ACADIA PHARMACEUTICALS INC
Form 10-K
March 10, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

Form 10-K

(Mark One)

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2010

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: 000-50768

ACADIA PHARMACEUTICALS INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware	06-1376651
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification Number)

3911 Sorrento Valley Boulevard

San Diego, California	92121
(Address of Principal Executive Offices)	(Zip Code)

Registrant s telephone number, including area code:

(858) 558-2871

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

Title of each class	Name of each exchange on which registered
Common Stock, par value $0.0001 per share	The NASDAQ Global Market

Securities registered pursuant to Section 12(g) of the Act: None

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

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. Yes ¨ No x

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

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 Securities Exchange Act of 1934:

Large accelerated filer ¨	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Securities Exchange Act of 1934). Yes ¨ No x

As of June 30, 2010, the last business day of the registrant s most recently completed second fiscal quarter, the aggregate market value of the registrant s common stock held by non-affiliates of the registrant was approximately $35.8 million, based on the closing price of the registrant s common stock on the NASDAQ Global Market on June 30, 2010 of $1.09 per share.

As of March 1, 2011, 51,921,766 shares of the registrant s common stock, $0.0001 par value, were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s definitive Proxy Statement to be filed with the Securities and Exchange Commission by May 2, 2011 are incorporated by reference into Part III of this report.

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PART I

FORWARD-LOOKING STATEMENTS

This report and the information incorporated herein by reference contain forward-looking statements that involve a number of risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. Although our forward-looking statements reflect the good faith judgment of our management, these statements can only be based on facts and factors currently known by us. Consequently, forward-looking statements are inherently subject to risks and uncertainties, and actual results and outcomes may differ materially from results and outcomes discussed in the forward-looking statements.

Forward-looking statements can be identified by the use of forward-looking words such as believes, expects, hopes, may, will, plans, in estimates, could, should, would, continue, seeks, aims, projects, predicts, pro forma, anticipates, potential or other simil use in the negative), or by discussions of future matters such as the development of product candidates or products, technology enhancements, possible changes in legislation, and other statements that are not historical. These statements include but are not limited to statements under the captions Business, Risk Factors, and Management s Discussion and Analysis of Financial Condition and Results of Operations as well as other sections in this report. You should be aware that the occurrence of any of the events discussed under the caption Risk Factors and elsewhere in this report could substantially harm our business, results of operations and financial condition. If any of these events occurs, the trading price of our common stock could decline and you could lose all or a part of the value of your shares of our common stock.

The cautionary statements made in this report are intended to be applicable to all related forward-looking statements wherever they may appear in this report. We urge you not to place undue reliance on these forward-looking statements, which speak only as of the date of this report.

Item 1. ***Business.***

Overview

We are a biopharmaceutical company focused on the development and commercialization of small molecule drugs for the treatment of central nervous system disorders. Our pipeline consists of four product candidates including pimavanserin, which is in Phase III development as a treatment for Parkinson s disease psychosis. We hold worldwide commercialization rights to pimavanserin. In addition, we have a product candidate in Phase II development for chronic pain and a product candidate in Phase I development for glaucoma, both in collaboration with Allergan, Inc., as well as a program in IND-track development in collaboration with Meiji Seika Kaisha, Ltd. All of the product candidates in our pipeline emanate from discoveries made using our proprietary drug discovery platform.

The product candidates in our pipeline address diseases that are not well served by currently available therapies and that represent large potential commercial opportunities. We believe our product candidates offer innovative therapeutic approaches and may provide significant advantages relative to current therapies. Our most advanced product candidates are as follows:

Pimavanserin**.** Pimavanserin is a new chemical entity that we discovered and have advanced to Phase III development as a potential first-in-class treatment for Parkinson s disease psychosis. Parkinson s disease psychosis is a debilitating psychiatric disorder that occurs in up to 40 percent of patients with Parkinson s disease and is associated with increased caregiver burden, nursing home placement, and increased mortality. The U.S. Food and Drug Administration, or FDA, has not approved any drug to treat Parkinson s disease psychosis. Pimavanserin provides an innovative approach to treating this disorder by selectively blocking a key serotonin

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receptor that plays an important role in psychosis. We believe pimavanserin may effectively treat Parkinson s disease psychosis without compromising motor control, thereby significantly improving the quality of life for patients with Parkinson s disease.

We are currently conducting several studies in our Phase III program with pimavanserin for Parkinson s disease psychosis, including a Phase III efficacy, tolerability and safety trial, and open-label safety extension studies. We also believe that pimavanserin has the potential to address a range of additional neurological and psychiatric disorders, including Alzheimer s disease psychosis and schizophrenia, which are underserved by currently marketed antipsychotic drugs. We have completed a Phase II trial with pimavanserin as a co-therapy in schizophrenia and have established plans for a future Phase II feasibility study to explore the use of pimavanserin as a treatment for Alzheimer s disease psychosis.

AGN-XX/YY. In collaboration with Allergan, we have discovered and are developing a new class of small molecule product candidates for the treatment of chronic pain. Chronic pain is a common form of persistent pain that may be related to a number of medical conditions and is often resistant to treatment. Allergan has conducted several Phase II trials in this program and has reported preliminary results from its Phase II program, including positive proof-of-concept in a human visceral pain trial and efficacy signals in two chronic pain trials in the areas of fibromyalgia and irritable bowel syndrome. Allergan has announced that it is seeking a partner for the further development of this program and for commercialization in areas predominantly served by general practitioners.

AC-262271. We have discovered and, in collaboration with Allergan, are developing a small molecule product candidate for the treatment of glaucoma. Glaucoma is a chronic eye disease and is the second leading cause of blindness in the world. AC-262271 has demonstrated a promising preclinical profile, including robust efficacy and a long duration of action. Allergan is conducting Phase I clinical trials in glaucoma patients with AC-262271.

AM-831. We have discovered and, in collaboration with Meiji Seika, are in IND-track development with AM-831, a small molecule product candidate for the treatment of schizophrenia. Currently prescribed treatments do not effectively address or may exacerbate cognitive disturbances associated with schizophrenia. We believe that AM-831 provides the potential for a new class of pro-cognitive antipsychotic drugs. We and Meiji Seika are currently conducting required development studies in preparation for potential future clinical trials with AM-831.

In addition to our four most advanced product candidates in development, we have used our proprietary drug discovery platform to discover additional product candidates that we may elect to develop in the future in partnerships or independently. We have demonstrated that our platform can be used to rapidly discover new compounds that may serve as potential treatments for significant unmet medical needs. Currently, we have focused our resources on our most advanced product candidates, including pimavanserin.

We have assembled a management team with significant industry experience to lead the discovery and development of our product candidates. We complement our management team with a group of scientific and clinical advisors that includes recognized experts in the fields of Parkinson s disease psychosis, schizophrenia, and other central nervous system disorders.

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We maintain a website at *www.acadia-pharm.com*, to which we regularly post copies of our press releases as well as additional information about us. Our filings with the Securities and Exchange Commission, or SEC, are available free of charge through our website as soon as reasonably practicable after being electronically filed

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with or furnished to the SEC. Interested persons can subscribe on our website to email alerts that are sent automatically when we issue press releases, file our reports with the SEC or post certain other information to our website. Information contained in our website does not constitute a part of this report or our other filings with the SEC.

Our Strategy

Our goal is to become a leader in the discovery, development, and commercialization of novel small molecule drugs for the treatment of central nervous system disorders and other areas of unmet medical need. Key elements of our strategy are to:

Develop and commercialize our lead product candidate, pimavanserin, for Parkinson s disease psychosis. We have selected Parkinson s disease psychosis as our lead indication for pimavanserin and we are currently focused on advancing our Phase III program for this indication. We plan to complete the development in this program in collaboration with partners or independently. If successful, we intend to participate in the commercialization of pimavanserin for Parkinson s disease psychosis in the United States by establishing a small specialty sales force that calls on a focused group of physicians. We plan to commercialize pimavanserin in markets outside of the United States by establishing one or more strategic alliances in the future.

Maximize the commercial potential of pimavanserin by expanding to additional neurological and psychiatric disorders. We intend to use our Phase III Parkinson s disease psychosis program as a foundation to develop and commercialize pimavanserin for additional neurological and psychiatric indications that also are underserved by currently available antipsychotics and represent large unmet medical needs. This may include development of pimavanserin as a treatment for Alzheimer s disease psychosis and as a co-therapy for schizophrenia. In therapeutic areas that involve an extensive development program or address larger specialty or primary care markets, we intend to complete late-stage development and commercialization through, or in collaboration with, partners. We may elect to retain selected commercialization rights in areas where we feel pimavanserin can be sold by a specialty sales force that calls on a focused group of physicians.

Continue to develop our other product candidates for the treatment of central nervous system and related disorders. We plan to continue developing our other product candidates, including our collaborative clinical programs with Allergan and our IND-track development program with Meiji Seika. While our resources are currently focused on our four most advanced product candidates, we may choose to pursue additional product candidates in the future. These may be directed at central nervous system disorders and may be developed in partnerships or independently. We believe that a diversified pipeline will mitigate the risks inherent in drug development and increase the likelihood of commercial success.

Opportunistically in-license or acquire complementary product candidates. Although all of the product candidates currently in our pipeline emanate from discoveries made using our proprietary platform, in the future, we may elect to in-license or acquire clinical-stage product candidates or products to augment our pipeline and to leverage any sales force that we may establish in the future.

Disease and Market Overview

Our product candidates address diseases that are not well served by currently available therapies and that represent large potential commercial market opportunities. Background information on the diseases and related commercial markets that may be addressed by our product candidates is set forth below.

Parkinson s Disease Psychosis

Parkinson s disease is a chronic and progressive neurological disorder that results from the degeneration of neurons in a region of the brain that controls movement. This degeneration creates a shortage of an important

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brain signaling chemical, or neurotransmitter, known as dopamine, thereby rendering patients unable to initiate their movements in a normal manner. Parkinson s disease is characterized by well-known motor symptoms including tremors, limb stiffness, slowness of movements, and difficulties with posture and balance, as well as by non-motor symptoms, which may include psychosis. The severity of Parkinson s disease symptoms tends to worsen over time.

According to the National Parkinson Foundation, over one million people in the United States and from four to six million people worldwide suffer from this disease. Parkinson s disease is more prevalent in people over 60 years of age, and the incidence of this disease is expected to increase as the average age of the population increases. Parkinson s disease patients are currently treated with dopamine replacement therapies such as levodopa, commonly referred to as L-dopa, which is metabolized to dopamine, and dopamine agonists, which are molecules that mimic the action of dopamine.

Studies have suggested that up to 40 percent of patients with Parkinson s disease will develop psychotic symptoms, commonly consisting of visual hallucinations and delusions. The development of psychosis in patients with Parkinson s disease often disrupts their ability to perform many of the activities of daily living that keeps them independent and active and deeply affects their quality of life. As a result, Parkinson s disease psychosis is associated with increased caregiver burden, nursing home placement, and increased mortality.

The FDA has not approved any therapy for Parkinson s disease psychosis. Physicians may attempt to address this disorder initially by decreasing the dose of the dopamine replacement drugs, which are administered to manage the motor symptoms of Parkinson s disease. However, this approach is generally not effective in alleviating psychotic symptoms in most patients and is often associated with a significant worsening of motor function in these patients. Despite substantial limitations, currently marketed antipsychotic drugs, including Seroquel, are used off-label to treat patients with Parkinson s disease psychosis. Because antipsychotic drugs block dopamine receptors, and thereby may counteract the dopamine therapy used to manage motor symptoms, these drugs are generally not well tolerated by patients with Parkinson s disease at doses required to achieve antipsychotic effects. Current antipsychotic drugs also are associated with a number of side effects, which can be problematic for elderly patients with Parkinson s disease. In addition, antipsychotic drugs have a black box warning for use in elderly patients with dementia-related psychosis due to increased mortality and morbidity.

The only current antipsychotic drug that has demonstrated efficacy in reducing psychosis in patients with Parkinson s disease without further impairing motor function is low-dose treatment with the generic drug clozapine. Studies suggest that this unique clinical utility of clozapine arises from its potent blocking of a key serotonin receptor, a protein that responds to the neurotransmitter serotonin, known as the 5-HT2A receptor. The use of low-dose clozapine has been approved in Europe, but not in the United States, for the treatment of psychotic disorders in Parkinson s disease. However, patients being treated with clozapine require frequent blood monitoring because clozapine treatment is associated with the occurrence of a rare blood disorder. Currently, there is a large unmet medical need for new therapies that will effectively treat psychosis in patients with Parkinson s disease without unwanted side effects, including impairment of motor function.

Schizophrenia

Schizophrenia is a chronic and debilitating mental illness characterized by disturbances in thinking, emotional reaction, and behavior. These disturbances may include positive symptoms, such as hallucinations and delusions, a range of negative symptoms, including loss of interest and emotional withdrawal, and cognitive disturbances. Schizophrenia is associated with persistent impairment of a patient s social functioning and productivity. Cognitive disturbances often prevent patients with schizophrenia from readjusting to society. As a result, patients with schizophrenia are normally required to be under medical care for their entire lives.

According to the National Institute of Mental Health, approximately one percent of the U.S. population suffers from this disease. Worldwide sales of antipsychotic drugs used to treat schizophrenia and other psychiatric conditions exceeded $23 billion in 2009. These drugs have been increasingly used by physicians to

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address a range of disorders in addition to schizophrenia, including bipolar disorder and a variety of psychoses and related conditions in elderly patients. Despite their commercial success, current antipsychotic drugs have substantial limitations, including inadequate efficacy and severe side effects.

The first-generation, or typical, antipsychotics that were introduced in the late-1950s block dopamine receptors. While typical antipsychotics are effective against positive symptoms of schizophrenia in many patients, these drugs often induce disabling motor disturbances, and they fail to address or worsen most of the negative symptoms and cognitive disturbances associated with schizophrenia.

Most schizophrenia patients in the United States today are treated with second-generation, or atypical, antipsychotics, which induce fewer motor disturbances than typical antipsychotics, but still fail to address most of the negative symptoms of schizophrenia. In addition, currently prescribed treatments do not effectively address or may exacerbate cognitive disturbances associated with schizophrenia. It is believed that the efficacy of atypical antipsychotics is due to their interactions with dopamine and 5-HT2A receptors. The side effects induced by the atypical agents may include weight gain, non-insulin dependent (type II) diabetes, cardiovascular side effects, and motor disturbances. We believe that these side effects arise either from non-essential receptor interactions or from excessive dopamine blockade.

The limitations of currently available antipsychotics result in poor patient compliance. A study conducted by the National Institute of Mental Health, which was published in *The New England Journal of Medicine* in September 2006, found that 74 percent of patients taking typical or atypical antipsychotics discontinued treatment within 18 months because of side effects or lack of efficacy. We believe there is a large unmet medical need for new therapies that have an improved side effect and efficacy profile.

Alzheimer s Disease Psychosis

Alzheimer s disease is a progressive neurodegenerative disorder that slowly destroys memory and thinking skills, and eventually even the ability to carry out simple tasks. Its symptoms include cognitive dysfunction, memory abnormalities, progressive impairment in activities of daily living, and a host of behavioral and neuropsychiatric symptoms. Alzheimer s disease primarily affects older people and, in most cases, symptoms first appear after age 60. Alzheimer s disease gets worse over time and is fatal.

According to the Alzheimer s Association, 5.3 million people in the Unites States are living with Alzheimer s disease. While the diagnostic criteria for Alzheimer s disease mostly focus on the related cognitive deficits, it is often the behavioral and psychiatric symptoms that are most troublesome for caregivers and lead to poor quality of life for patients. These symptoms include agitation, aggressive behaviors, and psychosis. Studies have suggested that approximately 25 to 50 percent of Alzheimer s disease patients may develop psychosis, commonly consisting of hallucinations and delusions. The diagnosis of Alzheimer s disease psychosis is associated with more rapid cognitive and functional decline and institutionalization.

There is no proven safe and effective therapy for Alzheimer s disease psychosis. As symptoms progress and become more severe, physicians often resort to off-label use of antipsychotic medications in these patients. Current antipsychotic drugs are associated with a number of side effects, which can be problematic for elderly patients with Alzheimer s disease. In addition, antipsychotic drugs may exacerbate the cognitive disturbances associated with Alzheimer s disease. Current antipsychotic drugs also have a black box warning for use in elderly patients with dementia-related psychosis due to increased mortality and morbidity. There is a large unmet medical need for a safe and effective therapy to treat the psychosis in patients with Alzheimer s disease.

Chronic Pain

Chronic pain is a common form of pain that persists or progresses over a long period of time. In contrast to acute pain that usually arises suddenly in response to an identifiable injury and is transient, chronic pain persists

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over time and is often resistant to medical treatments. Chronic pain may be related to a number of different medical conditions, including diabetes, arthritis, migraine, fibromyalgia, irritable bowel syndrome, cancer, shingles, and previous trauma or injury.

Hypersensitivity is a common feature of many chronic pain disorders, including fibromyalgia and irritable bowel syndrome. Fibromyalgia is characterized by chronic widespread muscle pain, stiffness and tenderness of muscles, tendons and joints without detectable inflammation. It also is often associated with fatigue, restless sleep, awakening tired, anxiety, depression and disturbances in bowel function. Fibromyalgia affects an estimated three to six million people in the United States, predominately women between the ages of 35 and 55. Irritable bowel syndrome is one of the most common ailments of the intestines and affects an estimated 15 percent of the U.S. population.

There are a variety of drugs used to treat patients with chronic pain, including anticonvulsants, selective serotonin and norepinephrine reuptake inhibitors, or SNRIs, tricyclic antidepressants, opioid painkillers, and non-steroidal anti-inflammatory agents. Currently, the leading drugs include Lyrica, an anticonvulsant approved for postherpetic neuralgia, diabetic neuropathic pain and fibromyalgia, and Cymbalta, an SNRI indicated for treatment of diabetic peripheral neuropathic pain, fibromyalgia, and major depressive disorder. Lyrica and Cymbalta had worldwide sales of $3.1 billion and $3.5 billion, respectively, in 2010. Lyrica is the successor to Neurontin, which was the first product to be approved by the FDA for the treatment of neuropathic pain and is now generic.

Only a portion of patients with neuropathic pain and fibromyalgia get meaningful relief from anticonvulsants and antidepressants. There are no drugs currently indicated for treatment of irritable bowel syndrome and other conditions accompanied by an enhanced internal sensation of pain in the United States. Side effects of anticonvulsants may include dizziness, somnolence, dry mouth, blurred vision, weight gain, and concentration or attention difficulties. Side effects of SNRIs may include nausea, vomiting, dizziness, sleep disturbances, constipation, dry mouth, anxiety, abnormal vision, headache and sexual dysfunction. Tricyclic antidepressants have long been used to treat depression and these agents may have pain-relieving effects in some patients. Common side effects of these agents include dry mouth, blurred vision, constipation, difficulty with urination, impaired thinking and tiredness.

Drugs such as opioid painkillers and non-steroidal anti-inflammatory agents that are effective in treating inflammatory and acute pain usually are not effective in treating chronic pain. Opioid painkillers also have significant adverse side effects that limit their usefulness, and prolonged use of these drugs can lead to the need for increasing dosage and potentially to addiction.

Due to these shortcomings of current therapies, we believe that there is a large unmet medical need for new chronic pain therapies with improved efficacy and side effect profiles.

Glaucoma

Glaucoma is a chronic eye disease that, if left untreated, can lead to blindness. According to the World Health Organization, glaucoma is the second leading cause of blindness in the world. Loss of vision is caused by degeneration of the optic nerve, which is responsible for carrying images from the eye to the brain. A frequent symptom of glaucoma is increased fluid pressure within the eye, referred to as intraocular pressure. In the early stages of the disease, there may be no symptoms. It is estimated that over four million people in the United States have glaucoma but only half of those know they have it. Older people are at a higher risk for glaucoma and the disease is more prevalent in people over 60 years of age. The incidence of glaucoma is expected to increase as the average age of the population increases.

Currently there are a variety of options available to treat glaucoma, including eye medications, laser procedures and surgery. These treatment options are intended to decrease intraocular pressure and, thereby, protect the optic nerve. Physicians often treat glaucoma with multiple classes of drugs to optimize therapy and

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minimize side effects. Drugs used to treat glaucoma include prostaglandin analogs such as Xalatan and Lumigan, beta blockers such as timolol, and alpha agonists such as Alphagan, as well as combined medications. Xalatan is the market leader for glaucoma treatment with worldwide sales of $1.7 billion in 2010. While Xalatan is an effective anti-glaucoma agent, it frequently causes increased pigmentation of the iris that may lead to a change in iris color, and may cause other side effects, including blurred vision and burning and stinging sensations in the eye. We believe there is a need for new and more effective drugs that can treat glaucoma with fewer side effects and help patients reduce the risk of losing their vision.

Our Product Candidates

We are focused on a portfolio of our four most advanced product candidates, consisting of three product candidates in clinical development and one product candidate in IND-track development for which we are conducting required development studies in preparation for potential future clinical trials. We believe that our product candidates offer innovative therapeutic approaches and may provide significant advantages relative to current therapies. The following table summarizes our most advanced product candidates:

Product Candidate	Indication	Stage of Development	Commercialization Rights
Pimavanserin	Parkinson s disease psychosis	Phase III	ACADIA
	Schizophrenia	Phase II	ACADIA
	Alzheimer s disease psychosis	Phase II (1)	ACADIA
AGN-XX/YY	Chronic Pain	Phase II	Allergan
AC-262271	Glaucoma	Phase I	Allergan
AM-831	Schizophrenia	IND-track	Meiji Seika Asia ACADIA Rest of World

(1) ACADIA has established a protocol for a future Phase II feasibility study in Alzheimer s disease psychosis.

Pimavanserin

Overview

Pimavanserin is a new chemical entity that we discovered and have advanced to Phase III development as a potential first-in-class treatment for Parkinson s disease psychosis. Pimavanserin is a small molecule product candidate that can be taken orally as a tablet once-a-day. Pimavanserin selectively blocks the activity of the 5-HT2A receptor, a drug target that plays an important role in psychosis. We hold worldwide rights to pimavanserin and have established a patent portfolio, which includes numerous issued patents generically covering pimavanserin as well as issued patents specifically covering pimavanserin in the United States, Europe and several additional countries.

We have selected Parkinson s disease psychosis as our lead indication for pimavanserin and we are currently focused on advancing our Phase III program for this indication. We also believe that pimavanserin has the potential to address a range of additional neurological and psychiatric indications that are undeserved by currently marketed antipsychotics. We have completed a Phase II trial with pimavanserin as a co-therapy in schizophrenia and have established a protocol for a future Phase II feasibility study to explore the potential of pimavanserin as a treatment for Alzheimer s disease psychosis. In the future, we intend to use our Phase III Parkinson s disease psychosis program as a foundation to develop and commercialize pimavanserin for these and other potential central nervous system indications through or in collaboration with strategic partners.

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Pimavanserin as a Treatment for Parkinson s Disease Psychosis

We are in Phase III development with pimavanserin as a treatment for Parkinson s disease psychosis. Currently, there are no therapies approved to treat Parkinson s disease psychosis in the United States. We believe that pimavanserin may effectively treat the psychosis in patients with Parkinson s disease without compromising motor control, thereby significantly improving the quality of life for these patients. As a result, we believe that, if approved, pimavanserin will offer significant advantages relative to current antipsychotics used off-label for the treatment of Parkinson s disease psychosis.

We are currently conducting several studies in our Phase III program with pimavanserin for Parkinson s disease psychosis, including a Phase III trial, referred to as the -020 Study, designed to evaluate the efficacy, tolerability and safety of pimavanserin as a treatment for patients with Parkinson s disease psychosis. The -020 Study is multi-center, double-blind, placebo-controlled trial expected to enroll about 200 patients at clinical centers located in the United States. Patients are randomized to two study arms and receive oral doses of either 40 mg of pimavanserin or placebo once-daily for six weeks. Patients also continue to receive stable doses of their existing dopamine replacement therapy used to manage the motor symptoms of Parkinson s disease. The primary endpoint of the -020 Study is antipsychotic efficacy as measured using 9 items from the hallucinations and delusions domains of the Scale for the Assessment of Positive Symptoms, or SAPS. We employ independent centralized ratings to assess the primary endpoint in the -020 Study. Motoric tolerability is a key secondary endpoint in the study and is measured using Parts II and III of the Unified Parkinson s Disease Rating Scale, or UPDRS. The -020 Study builds on the signals of efficacy observed in our earlier studies and incorporates several study design enhancements based on the previous data and experience we have gained in our Parkinson s disease program.

In addition to the -020 Study, we are continuing to conduct an open-label safety extension study, referred to as the -015 Study, involving patients with Parkinson s disease psychosis who have completed our earlier Phase III studies as well as patients who complete the -020 Study. Patients are eligible to participate in the -015 Study if, in the opinion of the treating physician, the patient may benefit from continued treatment with pimavanserin. The -015 Study, together with a similar extension study that is still ongoing from our earlier Phase II Parkinson s disease psychosis trial, has generated a considerable amount of long-term safety data on pimavanserin. A total of over 200 patients have now been treated with pimavanserin for over one year and our longest single-patient exposure is greater than six years. We believe that our experience to date suggests that long-term administration of pimavanserin is safe and well tolerated in this fragile, elderly patient population.

In September 2009, we announced top-line results from an initial Phase III trial with pimavanserin in patients with Parkinson s disease psychosis, referred to as the -012 Study. While the -012 Study was impacted by a larger than expected placebo response and did not meet its primary endpoint, signals of antipsychotic efficacy were consistently observed in the pimavanserin 40 mg study arm. These signals were most prominent in the United States portion of the study, which comprised nearly one-half of the patients in the study. The -012 Study met the key secondary endpoint of motoric tolerability and pimavanserin was safe and well tolerated in the study. On the basis of data from the -012 Study, during 2010 we concluded a second Phase III trial, referred to as the -014 Study, early and analyzed this study in order to use the findings to support our design of the -020 Study. In the -014 Study, the 20 mg pimavanserin arm showed a signal of efficacy on the primary assessment scale and a statistically significant difference from placebo on a secondary outcome measure. The -014 Study met the key secondary endpoint of motoric tolerability and pimavanserin was safe and well tolerated in the study.

In 2006, we announced top-line results from a multi-center, double-blind, placebo-controlled Phase II clinical trial with pimavanserin in patients with Parkinson s disease psychosis. The trial met the primary endpoint, which was to demonstrate that administration of pimavanserin did not result in deterioration of the motoric function of these patients as measured by the UPDRS. Pimavanserin also showed antipsychotic effects in secondary endpoints using two different rating scales, including SAPS. Pimavanserin was safe and well tolerated in the study.

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Pimavanserin as a Co-Therapy for Schizophrenia

By combining pimavanserin with a low dose of an antipsychotic drug such as risperidone, a commonly prescribed atypical antipsychotic drug, we believe that the optimal relationship between 5-HT2A receptor blockade and partial dopamine receptor blockade can be achieved. Therefore, we believe co-therapy with pimavanserin may result in enhanced efficacy and fewer side effects relative to existing treatments, thereby providing an improved therapy for patients with schizophrenia and, potentially, related psychiatric disorders.

We reported positive results in 2007 from a multi-center, double-blind, placebo-controlled Phase II clinical trial designed to evaluate pimavanserin as a co-therapy in patients with schizophrenia. The trial results showed several advantages of co-therapy with pimavanserin and a 2 mg, or low, dose of risperidone in patients with schizophrenia. These advantages included enhanced efficacy comparable to that of a 6 mg, or standard, dose of risperidone, a faster onset of antipsychotic action, and an improved side effect profile, including significantly less weight gain, compared to the standard dose of risperidone. If we elect to pursue further development for this indication in the future, we expect that it will be through, or in collaboration with, a partner.

Pimavanserin as a Treatment for Alzheimer s Disease Psychosis

Patients with Alzheimer s disease psychosis and Parkinson s disease psychosis share many common characteristics. They are typically elderly and frail, and often exhibit similar psychiatric symptoms associated with their underlying neurodegenerative disease. In preclinical models of Alzheimer s disease psychosis, we have shown that pimavanserin attenuates psychosis-related behaviors in those models. In addition, pimavanserin has been shown to positively interact with muscarinic agonists and cholinesterase inhibitors to enhance their pro-cognitive and antipsychotic actions in preclinical models. Because of its mechanism of action and the favorable safety profile observed to date in studies conducted in elderly patients with Parkinson s disease psychosis, we believe that pimavanserin also may be ideally suited to address the need for a new treatment for Alzheimer s disease psychosis that is safe, effective and well tolerated.

We have established a protocol for a Phase II feasibility study to evaluate the potential of pimavanserin as a treatment for Alzheimer s disease psychosis. While our resources are currently focused on our Phase III program in Parkinson s disease psychosis, we intend to pursue our planned feasibility study in Alzheimer s disease psychosis in the future independently or in collaboration with a partner.

AGN-XX/YY

In collaboration with Allergan, we have discovered and are developing a new class of small molecule product candidates for the treatment of chronic pain. Our novel alpha adrenergic agonists provide pain relief in a range of preclinical models, without the side effects of current pain therapies, including sedation and cardiovascular and respiratory effects.

Allergan has conducted several Phase II trials in this program and has reported preliminary results from its Phase II program, including positive proof-of-concept in a visceral pain trial in patients that had hypersensitivity of the esophagus, and efficacy signals in two chronic pain trials in the areas of fibromyalgia and irritable bowel syndrome. Allergan has announced that it is seeking a partner for the further development of this program and for commercialization in areas predominantly served by general practitioners.

AC-262271

We have discovered and, in collaboration with Allergan, are developing AC-262271, a small molecule product candidate for the treatment of glaucoma. Using our proprietary drug discovery platform, we identified a subtype of the muscarinic receptors that controls intraocular pressure and discovered lead compounds that selectively activate this target. In preclinical models, AC-262271 has demonstrated a promising preclinical profile, including robust efficacy and a long duration of action. Allergan is conducting Phase I clinical trials in glaucoma patients with AC-262271.

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AM-831

We have discovered and, in collaboration with Meiji Seika, are in IND-track development with AM-831, a small molecule product candidate for the treatment of schizophrenia and related psychiatric disorders. AM-831 was selected from a series of lead compounds that provide the potential for a new class of pro-cognitive antipsychotic drugs. These compounds combine muscarinic m1 agonism with actions on both dopamine and serotonin receptors. AM-831 has demonstrated robust effects in animal models of psychosis and pro-cognitive effects in animal models of cognition.

In collaboration with Meiji Seika, we are conducting required development studies in preparation for potential future clinical trials. We intend to co-develop AM-831 in collaboration with Meiji Seika through completion of proof-of-concept clinical studies, at which point Meiji Seika will be solely responsible for continued development and commercialization in Asia and we plan to seek a strategic partner to pursue development and commercialization in the rest of the world.

Other Product Candidates

In addition to our four most advanced product candidates in development, we have used our proprietary drug discovery platform to discover additional product candidates. These include two preclinical programs in the area of Parkinson s disease. The first is our ER-beta program where we have discovered compounds that may possess neuroprotective and anti-inflammatory properties and may have the ability to slow down the progression of Parkinson s disease. Our initial research studies of these ER-beta compounds have been supported by grants from The Michael J. Fox Foundation. In the second preclinical program, we discovered compounds that selectively activate Nurr1-RXR complexes and promote viability of dopamine-containing neurons. We are conducting studies to examine the effects of these compounds on neuroprotection and neuroregeneration in preclinical models of Parkinson s disease pursuant to another grant from The Michael J. Fox Foundation.

Currently, our resources are focused on our most advanced product candidates, including pimavanserin, and we are not devoting significant resources to earlier-stage programs that are not directly funded. However, we may elect to pursue the development of additional product candidates in the future in partnerships or independently.

Our Drug Discovery Platform and Capabilities

Overview

All of our product candidates that are currently in clinical trials and earlier stages of discovery and development emanate from discoveries made using our proprietary drug discovery platform. We have demonstrated that our platform can be used to rapidly identify drug-like, small molecule chemistries for a wide range of drug targets. We believe that our expertise combined with our proprietary platform has allowed us to discover product candidates more efficiently than traditional approaches.

Our Drug Discovery Approach

Our drug discovery approach is designed to introduce chemistry at an early stage in the drug discovery process and enable selection of the most attractive, drug-like chemistries for desired targets. A key to our discovery approach has been our set of proprietary functional test systems, or assays, that we developed for a large number of targets predominantly in the G-protein coupled receptor and nuclear receptor gene families. We believe that these gene families represent the most relevant and feasible targets for small molecule drug discovery focused on central nervous system indications. We have used our proprietary assays in conjunction with our proprietary receptor selection and amplification technology, a cell-based assay system which we refer to as R-SAT, to validate drug targets, and to discover novel small molecules that are specific for these targets.

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Collaboration Agreements

We have established three separate collaboration agreements with Allergan, a collaboration agreement with Meiji Seika and a technology license agreement with Aventis to leverage our drug discovery platform and related assets, and to advance development of and commercialize selected product candidates. Our collaborations have typically included upfront payments at initiation of the collaboration, research support during the research term, if applicable, milestone payments upon successful completion of specified development objectives, and royalties based upon sales, if any, of drugs developed under the collaboration. Our current agreements are as follows:

Allergan

In March 2003, we entered into a collaboration agreement with Allergan to discover, develop and commercialize new therapeutics for ophthalmic and other indications. The agreement originally provided for a three-year research term, which has been extended by the parties through March 2011. As of December 31, 2010, we had received an aggregate of $17.4 million under the agreement, consisting of an upfront payment, and research funding and related fees. During the extended research term, Allergan is entitled to exclusively license specified chemistry and related assets for development and commercialization. If we grant Allergan such an exclusive license, we would be eligible to receive license fees and milestone payments upon the successful achievement of agreed-upon clinical and regulatory objectives as well as royalties on future product sales, if any, worldwide. Assuming the license and successful development of a product in the area of eye care, we could receive up to approximately $13.5 million in aggregate license fees and milestone payments per product under the agreement, as well as royalties on future product sales worldwide, if any.

In July 1999, we entered into a collaboration agreement with Allergan to discover, develop and commercialize selective muscarinic drugs for the treatment of glaucoma. Under this agreement, we provided our chemistry and discovery expertise to enable Allergan to select a compound for development. We granted Allergan exclusive worldwide rights to commercialize products based on this compound for the treatment of ocular disease, which program is currently in Phase I development. As of December 31, 2010, we had received an aggregate of $9.4 million in payments under the agreement, consisting of upfront fees, research funding and milestone payments. We are eligible to receive additional milestone payments of up to $15 million in the aggregate as well as royalties on future product sales worldwide, if any. Allergan may terminate this agreement upon 90 days notice. However, if terminated, Allergan s rights to the selected compound would revert to us.

In September 1997, we entered into a collaboration agreement with Allergan focused primarily on the discovery and development of new therapeutics for pain, which program is in Phase II development, and ophthalmic indications. This agreement was amended in conjunction with the execution and subsequent amendments of the March 2003 collaboration agreement, and provides for the continued development of product candidates for one target area. We are restricted from conducting competing research in that target area. Pursuant to the agreement, we granted Allergan exclusive worldwide rights to commercialize products resulting from the collaboration. We had received an aggregate of $10.5 million in research funding and milestone payments through December 31, 2010 under this agreement. We are eligible to receive additional milestone payments of up to $10.0 million in the aggregate as well as royalties on future product sales worldwide, if any. In connection with the execution of the collaboration agreement in 1997, Allergan made a $6.0 million equity investment in us.

The general terms of our collaboration agreements with Allergan continue until the later of the expiration of the last to expire patent covering a product licensed under the collaboration and at least 10 years from the date of first commercial sale of a product. In addition, each of our Allergan collaboration agreements includes a research term that is shorter but may be renewed if agreed to by the parties.

Meiji Seika Kaisha

In March 2009, we entered into a collaboration agreement with Meiji Seika to develop and commercialize a novel class of pro-cognitive drugs to treat patients with schizophrenia and related disorders in Japan and several other Asian countries. Under the agreement, we are eligible to receive up to $25 million in aggregate payments,

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including $3 million in license fees and up to $22 million in potential development and regulatory milestone payments, as well as royalties on product sales, if any, in the Asian territory. Meiji Seika also is responsible for the first $15 million of development expenses and we and Meiji Seika will share remaining expenses through clinical proof-of-concept, subject to possible adjustment in the event we further license the program outside of the Asian territory. Meiji Seika is responsible for all costs associated with the development, manufacturing and commercialization of the product candidate in the Asian territory, and is eligible to share a portion of any product-related revenues received by us in the rest of the world. As of December 31, 2010, we had received an aggregate of $4.1 million in payments under the agreement, including $3 million in license fees and reimbursement of initial development expenses. Our agreement with Meiji Seika is subject to early termination upon specified events.

Aventis

In July 2002, we entered into an agreement with Aventis under which we have licensed a portion of our technology for their use in a specified area that we are not pursuing presently.

Intellectual Property

We currently hold 46 issued U.S. patents and 199 issued foreign patents. All of these patents originated from us. In addition, we have 24 provisional and utility U.S. patent applications and 142 foreign patent applications.

Patents or other proprietary rights are an essential element of our business. Our strategy is to file patent applications in the United States and any other country that represents an important potential commercial market to us. In addition, we seek to protect our technology, inventions and improvements to inventions that are important to the development of our business. Our patent applications claim proprietary technology, including methods of screening and chemical synthetic methods, novel drug targets and novel compounds identified using our technology.

We also rely upon trade secret rights to protect other technologies that may be used to discover and validate targets and that may be used to identify and develop novel drugs. We protect our trade secrets in part through confidentiality and proprietary information agreements. We have entered into a license agreement, dated as of November 30, 2006, for certain intellectual property rights from the Ipsen Group in order to expand and strengthen the intellectual property portfolio for our serotonin platform. We are a party to various other license agreements that give us rights to use certain technologies in our research and development.

Pimavanserin

Seven U.S. patents have been issued to us that provide coverage for pimavanserin, comprising two that cover the compound generically and five that specifically cover pimavanserin, polymorphs thereof, or use thereof for treating Parkinson s disease psychosis, schizophrenia, and sleep disorders. The generic coverage expires in 2021. The pimavanserin specific patent and the Parkinson s disease psychosis treatment patent provide protection until June 2027 and 2026, respectively. The patent that covers polymorphs of pimavanserin provides protection until June 2028. We have 35 issued foreign patents that specifically cover pimavanserin, including patents in 25 European countries, Australia, Hong Kong, India, Mexico, New Zealand, Russia, Singapore and South Africa, which provide patent protection through 2024. We continue to prosecute patent applications directed to pimavanserin and to methods of treating various diseases using pimavanserin, either alone or in combination with other agents, worldwide.

AGN-XX/YY

We have not been issued, and are not pursuing, patents covering the compounds being pursued by Allergan under this collaboration as the compounds are covered by Allergan patents.

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AC-262271

We have two U.S. patents that have been issued to us providing coverage for the compounds covered by our collaboration with Allergan for the treatment of glaucoma. These U.S. patents will expire in 2023. We have 41 issued foreign patents and 19 pending foreign applications that cover these compounds. The issued foreign patents for this program will expire in 2022 and 2025.

AM-831

Two U.S. patents have been issued to us that provide coverage for the compounds covered by our collaboration with Meiji Seika. These patents expire in 2024 and 2026. We have 34 issued foreign patents that cover these compounds. These patents provide protection through 2024.

Other Product Candidates

We have 17 issued U.S. patents and 33 issued foreign patents with claims for other product candidates that are at earlier stages of development.

Our Drug Discovery Platform

Our core R-SAT technology is protected by eight issued U.S. patents and 17 foreign patents. Our U.S. patents for R-SAT will expire over the range of 2013 to 2025. The foreign patents covering R-SAT will expire over the range of 2014 to 2024.

Competition

We face, and will continue to face, intense competition from pharmaceutical and biotechnology companies, as well as numerous academic and research institutions and governmental agencies, both in the United States and abroad. We compete or will compete, as applicable, with existing and new products being developed by our competitors. Some of these competitors are pursuing the development of pharmaceuticals that target the same diseases and conditions that our research and development programs target. In each of our clinical programs, we intend to complete clinical trials designed to evaluate the potential advantages of our product candidates as compared to the current standard of care.

Even if we and our collaborators are successful in developing our product candidates, the resulting products would compete with a variety of established drugs in the areas of Parkinson s disease psychosis, schizophrenia, Alzheimer s disease psychosis, chronic pain, and glaucoma. For example, our potential product for the treatment of Parkinson s disease psychosis will compete with off-label use of antipsychotic drugs, including Seroquel, marketed by Astra-Zeneca, and clozapine, a generic drug.

Our potential products for the treatment of schizophrenia would compete with Zyprexa, marketed by Eli Lilly, Risperdal, marketed by Johnson & Johnson, Abilify, marketed jointly by Bristol-Myers Squibb and Otsuka Pharmaceutical, Seroquel, and clozapine. Our potential product for Alzheimer s disease psychosis would compete with off-label use of antipsychotic drugs.

Our potential products for the treatment of chronic pain would compete with Neurontin and Lyrica, each marketed by Pfizer, and Cymbalta, marketed by Eli Lilly, as well as with a variety of generic or proprietary opioids. Currently, the leading drugs approved for chronic pain indications include Lyrica, the successor to Neurontin, and Cymbalta. Lyrica had worldwide sales of $3.1 billion in 2010. Cymbalta, indicated for treatment of diabetic peripheral neuropathic pain as well as treatment of major depressive disorder, had worldwide sales of $3.5 billion in 2010.

Our potential products for the treatment of glaucoma would compete with Xalatan, marketed by Pfizer, and Lumigan and Alphagan, marketed by Allergan. Xalatan is the leading drug for glaucoma treatment and had worldwide sales of $1.7 billion in 2010.

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In addition, the companies described above and other competitors may have a variety of drugs in development or awaiting FDA approval that could reach the market and become established before we have a product to sell. Our competitors may also develop alternative therapies that could further limit the market for any drugs that we may develop. Some of our competitors are using functional genomics technologies or other methods to identify and validate drug targets and to discover novel small molecule drugs. Many of our competitors and their collaborators have significantly greater experience than we do in the following:

- identifying and validating targets;
- screening compounds against targets;
- preclinical and clinical trials of potential pharmaceutical products; and
- obtaining FDA and other regulatory clearances.

In addition, many of our competitors and their collaborators have substantially greater advantages in the following areas:

- capital resources;
- research and development resources;
- manufacturing capabilities; and
- sales and marketing.

Smaller companies also may prove to be significant competitors, particularly through proprietary research discoveries and collaborative arrangements with large pharmaceutical and established biotechnology companies. Many of our competitors have products that have been approved or are in advanced development. We face competition from other companies, academic institutions, governmental agencies and other public and private research organizations for collaborative arrangements with pharmaceutical and biotechnology companies, in recruiting and retaining highly qualified scientific and management personnel and for licenses to additional technologies. Our competitors, either alone or with their collaborators, may succeed in developing technologies or drugs that are more effective, safer, and more affordable or more easily administered than ours and may achieve patent protection or commercialize drugs sooner than us. Developments by others may render our product candidates or our technologies obsolete. Our failure to compete effectively could have a material adverse affect on our business.

Government Regulation

The manufacturing and marketing of our potential products and our ongoing research and development activities are subject to extensive regulation by numerous governmental authorities in the United States and other countries. Before marketing in the United States, any new drug developed by us must undergo rigorous preclinical testing, clinical trials and an extensive regulatory clearance process implemented by the FDA under the federal Food, Drug, and Cosmetic Act, as amended. The FDA regulates, among other things, the development, testing, manufacture, safety, efficacy, record keeping, labeling, storage, approval, advertising, promotion, sale and distribution of biopharmaceutical products. None of our product candidates has been approved for sale in the United States or any foreign market. The regulatory review and approval process, which includes preclinical testing and clinical trials of each product candidate, is lengthy, expensive and uncertain.

In the United States, product candidates are tested in animals until adequate proof of safety is established. Clinical trials for new product candidates are typically conducted in three sequential phases that may overlap. Phase I trials involve the initial introduction of the product candidate into healthy human volunteers. The emphasis of Phase I trials is on testing for safety or adverse effects, dosage, tolerance, metabolism,

distribution, excretion and clinical pharmacology. Phase II involves studies in a limited patient population to determine the initial efficacy of the compound for specific targeted indications, to determine dosage tolerance and optimal dosage and to identify possible adverse side effects and safety risks. Once a compound shows evidence of

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effectiveness and is found to have an acceptable safety profile in Phase II evaluations, Phase III trials are undertaken to more fully evaluate clinical outcomes. Before commencing clinical investigations in humans, we or our collaborators must submit to the FDA an Investigational New Drug Application, or IND.

Regulatory authorities may require additional data before allowing the clinical studies to commence or proceed from one phase to another, and could demand that the studies be discontinued or suspended at any time if there are significant safety issues. We have in the past and may in the future rely on some of our collaborators to file INDs and generally direct the regulatory approval process for many of our potential products. Clinical testing must also meet requirements for clinical trial registration, institutional review board oversight, informed consent, health information privacy, and good clinical practices.

To establish a new product candidate s safety and efficacy, the FDA requires companies seeking approval to market a drug product to submit extensive preclinical and clinical data, along with other information, for each indication. The data and information are submitted to the FDA in the form of a New Drug Application, or NDA. Generating the required data and information for an NDA takes many years and requires the expenditure of substantial resources. Information generated in this process is susceptible to varying interpretations that could delay, limit or prevent regulatory approval at any stage of the process. The failure to demonstrate adequately the quality, safety and efficacy of a product candidate under development would delay or prevent regulatory approval of the product candidate. We cannot assure you that, even if clinical trials are completed, either our collaborators or we will submit applications for required authorizations to manufacture and/or market potential products or that any such application will be reviewed and approved by the appropriate regulatory authorities in a timely manner, if at all. Under applicable laws and FDA regulations, each NDA submitted for FDA approval is usually given an internal administrative review within 60 days following submission of the NDA. If deemed sufficiently complete to permit a substantive review, the FDA will file the NDA. The FDA can refuse to file any NDA that it deems incomplete or not properly reviewable. The FDA has established internal goals of six months for priority review for NDAs that cover product candidates that offer major advances in treatment or provide a treatment where no adequate therapy exists, and 10 months for the standard review of non-priority NDAs. However, the FDA is not legally required to complete its review within these periods and these performance goals may change over time. Moreover, the outcome of the review, even if generally favorable, may not be an actual approval but a response letter that describes additional work that must be done before the NDA can be approved. The FDA s review of an NDA may involve review and recommendations by an independent FDA advisory committee.

Before receiving FDA approval to market a potential product, we or our collaborators must demonstrate through adequate and well-controlled clinical studies that the potential product is safe and effective on the patient population that will be treated. If regulatory approval of a potential product is granted, this approval will be limited to those disease states and conditions for which the product is approved. Marketing or promoting a drug for an unapproved indication is generally prohibited. Furthermore, FDA approval may entail ongoing requirements for risk management, including post-marketing studies. Even if approval is obtained, a marketed product, its manufacturer and its manufacturing facilities are subject to continuing review and periodic inspections by the FDA. Discovery of previously unknown problems with a product, manufacturer or facility may result in restrictions on the product or manufacturer, including labeling changes,
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2,848

Long-term income tax payable

3,265

3,113

Deferred income taxes

914

836

Total long-term liabilities

27,775

26,552

TOTAL LIABILITIES

173,497

157,147

SHAREHOLDERS' EQUITY:

Common Stock, no par value, authorized 120,000,000 shares; 44,511,290 and 44,372,357 shares issued and outstanding at July 29, 2017 and April 29, 2017, respectively

53,561

52,530

Additional paid-in capital

38,677

38,004

Retained earnings

119,302

113,967

Treasury Stock, at cost, 303,957 shares at July 29, 2017 and April 29, 2017, respectively

(1,834
)

(1,834
)

Accumulated other comprehensive loss

(3,307
)

(4,381
)

TOTAL SHAREHOLDERS' EQUITY

206,399

198,286

TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY

$
379,896

$
355,433

See notes to consolidated financial statements.

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DAKTRONICS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

	Three Months Ended	
	July 29, 2017	July 30, 2016
Net sales	$172,728	$157,146
Cost of goods sold	128,082	118,079
Gross profit	44,646	39,067
Operating expenses:		
Selling expense	14,939	15,259
General and administrative	8,935	8,783
Product design and development	9,047	7,043
	32,921	31,085
Operating income	11,725	7,982
Nonoperating income (expense):		
Interest income	211	205
Interest expense	(86)	(42)
Other income (expense), net	145	(94)
Income before income taxes	11,995	8,051
Income tax expense	3,566	2,512
Net income	$8,429	$5,539
Weighted average shares outstanding:		
Basic	44,244	44,079
Diluted	44,461	44,141
Earnings per share:		
Basic	$0.19	$0.13
Diluted	$0.19	$0.13
Cash dividends declared per share	$0.07	$0.10

See notes to consolidated financial statements.

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DAKTRONICS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands)
(unaudited)

	Three Months Ended	
	July 29, 2017	July 30, 2016
Net income	$8,429	$5,539
Other comprehensive income (loss):		
Cumulative translation adjustments	1,081	(931)
Unrealized loss on available-for-sale securities, net of tax	(7)	(2)
Total other comprehensive income (loss), net of tax	1,074	(933)
Comprehensive income	$9,503	$4,606

See notes to consolidated financial statements.

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DAKTRONICS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Three Months Ended	
	July 29, 2017	July 30, 2016
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$8,429	$5,539
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization	4,460	4,600
(Gain) loss on sale of property, equipment and other assets	(17)	31
Share-based compensation	672	709
Equity in loss of affiliate	85	—
Provision for doubtful accounts	14	7
Deferred income taxes, net	30	3
Change in operating assets and liabilities	(18,586)	(4,291)
Net cash (used in) provided by operating activities	(4,913)	6,598
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(4,092)	(2,157)
Proceeds from sale of property, equipment and other assets	63	64
Purchases of marketable securities	—	(2,394)
Proceeds from sales or maturities of marketable securities	7,643	6,856
Purchases of equity investment	(607)	—
Net cash provided by investing activities	3,007	2,369
CASH FLOWS FROM FINANCING ACTIVITIES:		
Payments on notes payable	—	(4)
Proceeds from exercise of stock options	211	—
Principal payments on long-term obligations	(1,018)	(896)
Dividends paid	(3,094)	(4,409)
Payments for common shares repurchased	—	(1,825)
Net cash used in financing activities	(3,901)	(7,134)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	52	(383)
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(5,755)	1,450
CASH AND CASH EQUIVALENTS:		
Beginning of period	32,623	28,328
End of period	$26,868	$29,778
Supplemental disclosures of cash flow information:		
Cash payments for:		
Interest	$103	$104
Income taxes, net of refunds	1,586	50

Supplemental schedule of non-cash investing and financing activities:		
Demonstration equipment transferred to inventory	48	73
Purchase of property and equipment included in accounts payable	797	209
Contributions of common stock under the ESPP	820	—

See notes to consolidated financial statements.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share data)
(unaudited)

Note 1. Basis of Presentation and Summary of Critical Accounting Policies

In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of normal recurring adjustments) necessary to fairly present our financial position, results of operations and cash flows for the periods presented. The preparation of financial statements in conformity with U.S. generally accepted accounting principles ("GAAP") requires management to make estimates and assumptions affecting the reported amounts therein. Due to the inherent uncertainty involved in making estimates, actual results in future periods may differ from those estimates.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. GAAP have been condensed or omitted. The balance sheet at April 29, 2017 has been derived from the audited financial statements at that date, but it does not include all of the information and footnotes required by GAAP for complete financial statements. These financial statements should be read in conjunction with our financial statements and notes thereto for the year ended April 29, 2017, which are contained in our Annual Report on Form 10-K previously filed with the Securities and Exchange Commission. The results of operations for the interim periods presented are not necessarily indicative of results that may be expected for any other interim period or for the full fiscal year.

Daktronics, Inc. operates on a 52- to 53-week fiscal year, with our fiscal year ending on the Saturday closest to April 30 of each year. When April 30 falls on a Wednesday, the fiscal year ends on the preceding Saturday. Within each fiscal year, each quarter is comprised of 13-week periods following the beginning of each fiscal year. In each 53-week year, an additional week is added to the first quarter, and each of the last three quarters is comprised of a 13-week period. The three months ended July 29, 2017 and July 30, 2016 contained operating results for 13-weeks, respectively.

Investments in affiliates over which we have significant influence are accounted for under the equity method of accounting. Investments in affiliates over which we do not have the ability to exert significant influence over the affiliate's operating and financing activities are accounted for under the cost method of accounting. We have evaluated our relationships with our affiliates and have determined that these entities are not variable interest entities.

The aggregate amount of investments accounted for under the equity method was $3,200 and $2,678 at July 29, 2017 and April 29, 2017, respectively. The equity method requires us to report our share of losses up to our equity investment amount. Cash paid for investments in affiliates is included in the "Purchases of equity investment" line item in our consolidated statements of cash flows. Our proportional share of the respective affiliate’s earnings or losses is included in the "Other income (expense), net" line item in our consolidated statements of operations. As of the three months ended July 29, 2017, our share of the losses of our affiliates was $85.

The aggregate amount of investments accounted for under the cost method was $42 at July 29, 2017 and April 29, 2017, respectively. There have not been any identified events or changes in circumstances that may have a significant adverse effect on their fair value, and it is not practical to estimate their fair value.

Recent Accounting Pronouncements

New Accounting Standards Not Yet Adopted

In January 2017, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2017-04, Intangibles-Goodwill and Other (Topic 350), which simplifies the subsequent measurement of goodwill by removing the second step of the two-step impairment test. The amendment requires an entity to perform its annual, or interim goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. A goodwill impairment will be the amount by which a reporting unit’s carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. ASU 2017-04 is effective for interim and annual periods beginning after December 15, 2019, and will require adoption on a prospective basis. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. We are currently evaluating the effect that adopting ASU 2017-04 will have on our consolidated results of operations, cash flows, and financial position.

In October 2016, the FASB issued ASU 2016-16, Income Taxes (Topic 740) Intra-Entity Transfers of Assets Other than Inventory, which is intended to improve the accounting for the income tax consequences of intra-entity transfers of assets other than inventory. Current U.S. GAAP prohibits the recognition of current and deferred income taxes for an intra-entity asset transfer until the asset has been sold to an outside party, which is an exception to the principle of comprehensive recognition of current and deferred income taxes in U.S. GAAP. This update eliminates the exception by requiring entities to recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. ASU 2016-16 is effective for interim and annual periods beginning after

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December 15, 2017, with early adoption permitted. We are currently evaluating the effect that adopting ASU 2016-16 will have on our consolidated financial statements and related disclosures.

In June 2016, the FASB issued ASU 2016-13, Measurement of Credit Losses on Financial Instruments, which provides guidance regarding the measurement and recognition of credit impairment for certain financial assets. ASU 2016-13 is effective for interim and annual periods beginning after December 15, 2019, with early adoption permitted. We are currently evaluating the effect that adopting ASU 2016-13 will have on our consolidated financial statements and related disclosures.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842), which sets out the principles for the recognition, measurement, presentation and disclosure of leases for both parties to a contract (that is, lessees and lessors). ASU 2016-02 requires lessees to apply a dual approach, classifying leases as either finance or operating leases based on the principle of whether or not the lease is effectively a financed purchase of the leased asset by the lessee. This classification will determine whether the lease expense is recognized based on an effective interest method or on a straight-line basis over the term of the lease. A lessee is also required to record a right-of-use asset and a lease liability for all leases with a term of greater than 12 months regardless of their classification. ASU 2016-02 requires lessors to account for leases using an approach that is substantially equivalent to existing guidance for sales-type leases, direct financing leases and operating leases. ASU 2016-02 is effective for interim and annual periods beginning after December 15, 2018, with early adoption permitted. We are currently evaluating the effect that adopting ASU 2016-02 will have on our consolidated results of operations, cash flows, and financial position.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers. ASU 2014-09 is a comprehensive revenue recognition model that requires a company to recognize revenue from the transfer of goods or services to customers in an amount that reflects the consideration that the entity expects to receive in exchange for those goods or services. The FASB has also issued ASUs 2016-08, 2016-10, 2016-12, and 2016-20 to clarify guidance with respect to principal versus agent considerations and the identification of performance obligations and licensing, to issue guidance on certain narrow areas, and to add practical expedients. We will adopt ASU 2014-09 and related guidance during the first quarter of fiscal 2019. We have commenced a process to evaluate the impact of ASU 2014-09 on our contracts, including identifying potential differences that would result from applying the requirements of ASU 2014-09. In fiscal 2017, we made progress in reviewing our various types of revenue arrangements. We have also started drafting accounting policies and evaluating the disclosure requirements of ASU 2014-09 on our business processes, controls and systems. We plan to finalize this work during fiscal 2018 and provide training to those impacted in the organization. As a result of the review performed to date, we do not anticipate that the adoption will significantly change the timing or amount of revenue recognized. Therefore, we do not anticipate that the adoption of the standard will materially impact our consolidated results of operations and financial statements, other than the additional disclosure requirements.

Note 2. Earnings Per Share ("EPS")

Basic EPS is computed by dividing income attributable to common shareholders by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution which may occur if securities or other obligations to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock which share in our earnings.

The following is a reconciliation of the net income and common share amounts used in the calculation of basic and diluted EPS for the three months ended July 29, 2017 and July 30, 2016:

	Net income	Shares	Per share

			income
For the three months ended July 29, 2017			
Basic earnings per share	$ 8,429	44,244	$ 0.19
Dilution associated with stock compensation plans	—	217	—
Diluted earnings per share	$ 8,429	44,461	$ 0.19
For the three months ended July 30, 2016			
Basic earnings per share	$ 5,539	44,079	$ 0.13
Dilution associated with stock compensation plans	—	62	—
Diluted earnings per share	$ 5,539	44,141	$ 0.13

Options outstanding to purchase 1,580 shares of common stock with a weighted average exercise price of $12.48 for the three months ended July 29, 2017 and 2,603 shares of common stock with a weighted average exercise price of $13.50 for the three months ended July 30, 2016 were not included in the computation of diluted (loss) earnings per share because the effects would be anti-dilutive.

Note 3. Share Repurchase Program

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On June 17, 2016, our Board of Directors approved a stock repurchase program under which Daktronics, Inc. may purchase up to $40,000 of its outstanding shares of common stock. Under this program, we may repurchase shares from time to time in open market transactions and in privately negotiated transactions based on business, market, applicable legal requirements and other considerations. The repurchase program does not require the repurchase of a specific number of shares and may be terminated at any time. During the three months ended July 29, 2017, we had no repurchases of shares of our outstanding common stock. During the three months ended July 30, 2016, we repurchased 284 shares of common stock at a total cost of $1,825. As of July 29, 2017, we had $38,175 of remaining capacity under our current share repurchase program.

Note 4. Segment Disclosure

We have organized our business into five segments which meet the definition of reportable segments under Accounting Standards Codification ("ASC") 280-10, Segment Reporting: Commercial, Live Events, High School Park and Recreation, Transportation, and International. These segments are based on the type of customer or geography and are the same as our business units.

Our Commercial business unit primarily consists of sales of our video display systems, digital billboards, Galaxy® and Fuelight™ product lines to resellers (primarily sign companies), Out-of-Home ("OOH") companies, national retailers, quick-serve restaurants, casinos and petroleum retailers. Our Live Events business unit primarily consists of sales of integrated scoring and video display systems to college and professional sports facilities and convention centers and sales of our mobile display technology to video rental organizations and other live events type venues. Our High School Park and Recreation business unit primarily consists of sales of scoring systems, Galaxy® displays and video display systems to primary and secondary education facilities. Our Transportation business unit primarily consists of sales of our Vanguard® and Galaxy® product lines to governmental transportation departments, airlines and other transportation related customers. Our International business unit consists of sales of all product lines outside the United States and Canada. In our International business unit, we focus on product lines related to integrated scoring and video display systems for sports and commercial applications, OOH advertising products, and European transportation related products.

Our segment reporting presents results through contribution margin, which is comprised of gross profit less selling costs. Segment profit excludes general and administration expense, product development expense, interest income and expense, non-operating income and income tax expense. Assets are not allocated to the segments. Depreciation and amortization are allocated to each segment based on various financial measures; however, some depreciation and amortization are corporate in nature and remain unallocated. In general, our segments follow the same accounting policies as those described in Note 1 of our Annual Report on Form 10-K for the fiscal year ended April 29, 2017. Unabsorbed costs of domestic field sales and services infrastructure, including most field administrative staff, are allocated to the Commercial, Live Events, High School Park and Recreation, and Transportation business units based on cost of sales. Shared manufacturing, buildings and utilities, and procurement costs are allocated based on payroll dollars, square footage and various other financial measures.

We do not maintain information on sales by products; therefore, disclosure of such information is not practical.

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The following table sets forth certain financial information for each of our five operating segments for the periods indicated:

	Three Months Ended	
	July 29, 2017	July 30, 2016
Net sales:		
Commercial	$32,863	$36,254
Live Events	77,612	60,633
High School Park and Recreation	28,479	27,617
Transportation	18,912	14,286
International	14,862	18,356
	172,728	157,146
Contribution margin:		
Commercial	3,573	4,496
Live Events	13,737	8,875
High School Park and Recreation	7,747	6,999
Transportation	5,908	3,601
International	(1,258)	(163)
	29,707	23,808
Non-allocated operating expenses:		
General and administrative	8,935	8,783
Product design and development	9,047	7,043
Operating income	11,725	7,982
Nonoperating income (expense):		
Interest income	211	205
Interest expense	(86)	(42)
Other income (expense), net	145	(94)
Income before income taxes	11,995	8,051
Income tax expense	3,566	2,512
Net income	$8,429	$5,539
Depreciation and amortization:		
Commercial	$1,534	$1,567
Live Events	1,238	1,280
High School Park and Recreation	422	438
Transportation	294	322
International	281	329
Unallocated corporate depreciation	691	664
	$4,460	$4,600

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No single geographic area comprises a material amount of our net sales or property and equipment, net of accumulated depreciation, other than the United States. The following table presents information about net sales and property and equipment, net of accumulated depreciation, in the United States and elsewhere:

	Three Months Ended	
	July 29, 2017	July 30, 2016
Net sales:		
United States	$154,002	$135,018
Outside U.S.	18,726	22,128
	$172,728	$157,146

	July 29, 2017	April 29, 2017
Property and equipment, net of accumulated depreciation:		
United States	$60,248	$62,425
Outside U.S.	5,045	4,324
	$65,293	$66,749

We have numerous customers worldwide for sales of our products and services; therefore, we are not economically dependent on a limited number of customers for the sale of our products and services except with respect to our dependence on two major digital billboard customers in our Commercial business unit.

Note 5. Marketable Securities

We have a cash management program which provides for the investment of cash balances not used in current operations. We classify our investments in marketable securities as available-for-sale in accordance with the provisions of ASC 320, Investments – Debt and Equity Securities. Marketable securities classified as available-for-sale are reported at fair value with unrealized gains or losses, net of tax, reported in accumulated other comprehensive loss. As it relates to fixed income marketable securities, it is not likely we will be required to sell any of these investments before recovery of the entire amortized cost basis. In addition, as of July 29, 2017, we anticipate we will recover the entire amortized cost basis of such fixed income securities, and we have determined no other-than-temporary impairments associated with credit losses were required to be recognized. The cost of securities sold is based on the specific identification method. Where quoted market prices are not available, we use the market price of similar types of securities traded in the market to estimate fair value.

As of July 29, 2017 and April 29, 2017, our available-for-sale securities consisted of the following:

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Balance as of July 29, 2017				
Certificates of deposit	$ 11,028	$ —	$ —	$11,028
U.S. Government sponsored entities	7,667	—	(24)	7,643
Municipal bonds	6,333	16	—	6,349
	$ 25,028	$ 16	$ (24)	$25,020
Balance as of April 29, 2017				
Certificates of deposit	$ 12,487	$ —	$ —	$12,487
U.S. Government securities	400	—	—	400

U.S. Government sponsored entities	12,260	—	(22)	12,238
Municipal bonds	7,574	14	—	7,588
	$ 32,721	$ 14	$ (22)	$ 32,713

Realized gains or losses on investments are recorded in our consolidated statements of operations as other income (expense), net. Upon the sale of a security classified as available-for-sale, the security's specific unrealized gain (loss) is reclassified out of "accumulated other comprehensive loss" into earnings based on the specific identification method. In the three months ended July 29, 2017 and July 30, 2016, the reclassifications from accumulated other comprehensive loss to earnings were immaterial.

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All available-for-sale securities are classified as current assets, as they are readily available to support our current operating needs. The contractual maturities of available-for-sale debt securities as of July 29, 2017 were as follows:

	Less than 12 months	1-5 Years	Total
Certificates of deposit	$6,810	$4,218	$11,028
U.S. Government sponsored entities	998	6,645	7,643
Municipal bonds	2,406	3,943	6,349
	$10,214	$14,806	$25,020

Note 6. Business Combinations

ADFLOW Acquisition

We have a contingent liability related to a prior year acquisition of ADFLOW Networks, Inc. ("ADFLOW"), on March 15, 2016. For more information related to the ADFLOW acquisition, see Note 4. Business Combinations of our Annual Report on Form 10-K for the fiscal year ended April 30, 2016. The fair value of such contingent consideration is estimated as of the acquisition date, and subsequently at the end of each reporting period, using forecasted cash flows. Projecting future cash flows requires us to make significant estimates and assumptions regarding future events, conditions, or revenues being achieved under the subject contingent agreement as well as the appropriate discount rate. Such valuation techniques include one or more significant inputs that are not observable. See Note 12. Fair Value Measurement for more information.

Note 7. Goodwill

The changes in the carrying amount of goodwill related to each reportable segment for the three months ended July 29, 2017 were as follows:

	Live Events	Commercial	Transportation	International	Total
Balance as of April 29, 2017	$2,274	$ 3,199	$ 45	$ 2,294	$7,812
Foreign currency translation	33	223	32	171	459
Balance as of July 29, 2017	$2,307	$ 3,422	$ 77	$ 2,465	$8,271

We perform an analysis of goodwill on an annual basis, and it is tested for impairment more frequently if events or changes in circumstances indicate that an asset might be impaired. We complete this annual analysis during our third quarter of each fiscal year, based on the goodwill amount as of the first business day of our third fiscal quarter. The result of our analysis indicated no goodwill impairment existed for our third quarter in fiscal 2017, which began on October 30, 2016.

Note 8. Inventories

Inventories consisted of the following:

	July 29, 2017	April 29, 2017
Raw materials	$28,525	$24,801
Work-in-process	10,479	7,366
Finished goods	35,408	34,319
	$74,412	$66,486

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Note 9. Receivables

Accounts receivable are reported net of an allowance for doubtful accounts of $2,612 and $2,610 at July 29, 2017 and April 29, 2017, respectively. Included in accounts receivable as of July 29, 2017 and April 29, 2017 was $1,724 and $1,857, respectively, of retainage on construction-type contracts, all of which is expected to be collected within one year.

In connection with certain sales transactions, we have entered into sales contracts with installment payments exceeding six months and sales-type leases. The present value of these contracts and leases is recorded as a receivable as the revenue is recognized in accordance with U.S. GAAP, and profit is recognized to the extent the present value is in excess of cost. We generally retain a security interest in the equipment or in the cash flow generated by the equipment until the contract is paid. The present value of long-term contracts and lease receivables, including accrued interest and current maturities, was $4,403 and $4,890 as of July 29, 2017 and April 29, 2017, respectively. Contract and lease receivables bearing annual interest rates of 4.8 to 10.0 percent are due in varying annual installments through August 2024. The face amount of long-term receivables was $4,753 and $5,201 as of July 29, 2017 and April 29, 2017, respectively.

Note 10. Commitments and Contingencies

Litigation: We are a party to legal proceedings and claims which arise during the ordinary course of business. We review our legal proceedings and claims, regulatory reviews and inspections, and other legal matters on an ongoing basis and follow appropriate accounting guidance when making accrual and disclosure decisions. We establish accruals for those contingencies when the incurrence of a loss is probable and can be reasonably estimated, and we disclose the amount accrued and the amount of a reasonably possible loss in excess of the amount accrued, if such disclosure is necessary for our financial statements to not be misleading. We do not record an accrual when the likelihood of loss being incurred is probable, but the amount cannot be reasonably estimated, or when the loss is believed to be only reasonably possible or remote, although disclosures will be made for material matters as required by ASC 450-20, Contingencies - Loss Contingencies. Our assessment of whether a loss is reasonably possible or probable is based on our assessment and consultation with legal counsel regarding the ultimate outcome of the matter following all appeals.

As of July 29, 2017 and April 29, 2017, we did not believe there was a reasonable probability that any material loss for these various claims or legal actions, including reviews, inspections or other legal proceedings, if any, would be incurred. Accordingly, no material accrual or disclosure of a potential range of loss has been made related to these matters. In the opinion of management, the ultimate liability of all unresolved legal proceedings is not expected to have a material effect on our financial position, liquidity or capital resources.

Warranties: We offer a standard parts coverage warranty for periods varying from one to five years for most of our products. We also offer additional types of warranties to include on-site labor, routine maintenance and event support. In addition, the terms of warranties on some installations can vary from one to 10 years. The specific terms and conditions of these warranties vary primarily depending on the type of the product sold. We estimate the costs which may be incurred under the contractual warranty obligations and record a liability in the amount of such estimated costs at the time the revenue is recognized. Factors affecting our estimate of the cost of our warranty obligations include historical experience and expectations of future conditions. We continually assess the adequacy of our recorded warranty accruals and, to the extent we experience any changes in warranty claim activity or costs associated with servicing those claims, our accrued warranty obligation is adjusted accordingly.

During fiscal 2016, we discovered a warranty issue caused by a mechanical device failure within a module for displays primarily in our OOH applications built prior to fiscal 2013. The device failure causes a visual defect in the display. Over the past three years, we have deployed preventative maintenance to sites impacted and repaired the defective devices in our repair center. When certain site locations have exceeded an acceptable failure rate, we have refurbished the display to meet customers' expectations under contractual obligations. We increased our accrued warranty obligations by $783 during the three months ended July 29, 2017, $1,766 during fiscal 2017, $9,174 during fiscal 2016, and $1,168 during fiscal 2015 for probable and reasonably estimable costs to remediate this issue. As of July 29, 2017, we had $2,776 remaining in accrued warranty obligations for the estimate of probable future claims related to this issue. Although many of our contractual warranty arrangements are nearing expiration for products with this issue, we may incur additional discretionary costs to maintain customer relationships or for higher than expected failure rates. Accordingly, it is possible that the ultimate cost to resolve this matter may increase and be materially different from the amount of the current estimate and accrual.

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Changes in our warranty obligation for the three months ended July 29, 2017 consisted of the following:

	Amount
Beginning accrued warranty obligations	$27,899
Warranties issued during the period	4,128
Settlements made during the period	(3,493)
Changes in accrued warranty obligations for pre-existing warranties during the period, including expirations	1,219
Ending accrued warranty obligations	$29,753

Performance guarantees: We have entered into standby letters of credit and surety bonds with financial institutions relating to the guarantee of our future performance on contracts, primarily construction type contracts. As of July 29, 2017, we had outstanding letters of credit and surety bonds in the amount of $8,914 and $21,590, respectively. Performance guarantees are issued to certain customers to guarantee the operation and installation of the equipment and our ability to complete a contract. These performance guarantees have various terms, which are generally one year.

Leases: We lease vehicles, office space and equipment for various global sales and service locations, including manufacturing space in the United States and China. Some of these leases, including the lease for manufacturing facilities in Sioux Falls, South Dakota, include provisions for extensions or purchase. The lease for the facilities in Sioux Falls, South Dakota, can be extended for an additional five years past its current term, which ends March 31, 2022, and it contains an option to purchase the property subject to the lease from March 31, 2017 to March 31, 2022 for $9,000, which approximates fair value. If the lease is extended, the purchase option increases to $9,090 for the year ending March 31, 2023 and $9,180 for the year ending March 31, 2024. Rental expense for operating leases was $853 and $849 for the three months ended July 29, 2017 and July 30, 2016, respectively.

Future minimum payments under noncancelable operating leases, excluding executory costs such as management and maintenance fees, with initial or remaining terms of one year or more consisted of the following at July 29, 2017:

Fiscal years ending	Amount
2018	$ 2,065
2019	2,222
2020	1,884
2021	1,627
2022	1,325
Thereafter	404
	$ 9,527

Purchase commitments: From time to time, we commit to purchase inventory, advertising, cloud-based information systems, information technology maintenance and support services, and various other products and services over periods that extend beyond one year. As of July 29, 2017, we were obligated under the following conditional and unconditional purchase commitments, which included $375 in conditional purchase commitments:

Fiscal years ending	Amount
2018	$ 1,589
2019	1,030
2020	253
2021	253
2022	143
Thereafter	380
	$ 3,648

Note 11. Income Taxes

We are subject to U.S. Federal income tax as well as income taxes of multiple state jurisdictions. As a result of the completion of examinations by the Internal Revenue Service on prior years and the expiration of statutes of limitations, our fiscal years 2014, 2015, and 2016 are the remaining years open under statutes of limitations. Certain subsidiaries are also subject to income tax in several foreign jurisdictions which have open tax years varying by jurisdiction beginning in fiscal 2007.

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As of July 29, 2017, we had $3,265 of unrecognized tax benefits which would reduce our effective tax rate if recognized.

Note 12. Fair Value Measurement

ASC 820, Fair Value Measurement, defines fair value as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants at the measurement date. It also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The fair value hierarchy within ASC 820 distinguishes between the following three levels of inputs which may be utilized when measuring fair value.

Level 1 - Quoted prices in active markets for identical assets or liabilities.

Level 2 - Observable inputs other than quoted prices included within Level 1 for the assets or liabilities, either directly or indirectly (for example, quoted market prices for similar assets and liabilities in active markets or quoted market prices for identical assets or liabilities in markets not considered to be active, inputs other than quoted prices that are observable for the asset or liability, or market-corroborated input).

Level 3 - Unobservable inputs supported by little or no market activity based on our own assumptions used to measure assets and liabilities.

The following table sets forth by Level within the fair value hierarchy our financial assets and liabilities that were accounted for at fair value on a recurring basis at July 29, 2017 and April 29, 2017 according to the valuation techniques we used to determine their fair values. There have been no transfers of assets or liabilities among the fair value hierarchies presented.

	Fair Value Measurements			
	Level 1	Level 2	Level 3	Total
Balance as of July 29, 2017				
Cash and cash equivalents	$26,868	$—	$—	$26,868
Restricted cash	222	—	—	222
Available-for-sale securities:				
Certificates of deposit	—	11,028	—	11,028
U.S. Government sponsored entities	—	7,643	—	7,643
Municipal bonds	—	6,349	—	6,349
Derivatives - asset position	—	31	—	31
Derivatives - liability position	—	(602)	—	(602)
Contingent liability	—	—	(1,004)	(1,004)
	$27,090	$24,449	$(1,004)	$50,535
Balance as of April 29, 2017				
Cash and cash equivalents	$32,623	$—	$—	$32,623
Restricted cash	216	—	—	216
Available-for-sale securities:				
Certificates of deposit	—	12,487	—	12,487
U.S. Government securities	400	—	—	400
U.S. Government sponsored entities	—	12,238	—	12,238
Municipal bonds	—	7,588	—	7,588
Derivatives - asset position	—	64	—	64
Derivatives - liability position	—	(277)	—	(277)

Contingent liability	—	—	(1,891)	(1,891)
	$33,239	$32,100	$(1,891)	$63,448

A roll forward of the Level 3 contingent liability, both short- and long-term, for the three months ended July 29, 2017 is as follows:

Contingent liability as of April 29, 2017	$1,891
Settlements	(1,009)
Interest	13
Foreign currency translation	109
Contingent liability as of July 29, 2017	$1,004

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The following methods and assumptions were used to estimate the fair value of each class of financial instrument. There have been no changes in the valuation techniques used by us to value our financial instruments.

Cash and cash equivalents: Consists of cash on hand in bank deposits and highly liquid investments, primarily money market accounts. The fair value was measured using quoted market prices in active markets. The carrying amount approximates fair value.

Restricted cash: Consists of cash and cash equivalents held in bank deposit accounts to secure issuances of foreign bank guarantees. The fair value of restricted cash was measured using quoted market prices in active markets. The carrying amount approximates fair value.

Certificates of deposit: Consists of time deposit accounts with original maturities of less than three years and various yields. The fair value of these securities was measured based on valuations observed in less active markets than Level 1 investments from a third-party financial institution. The carrying amount approximates fair value.

U.S. Government securities: Consists of U.S. Government treasury bills, notes, and bonds with original maturities of less than three years and various yields. The fair value of these securities was measured using quoted market prices in active markets.

U.S. Government sponsored entities: Consists of Fannie Mae and Federal Home Loan Bank investment grade debt securities trading with sufficient frequency and volume to enable us to obtain pricing information on an ongoing basis. The fair value of these securities was measured based on valuations observed in less active markets than Level 1 investments. The contractual maturities of these investments vary from one month to three years.

Municipal bonds: Consist of investment grade municipal bonds trading with sufficient frequency and volume to enable us to obtain pricing information on an ongoing basis. The contractual maturities of these investments vary from two to three years. The fair value of these bonds was measured based on valuations observed in less active markets than Level 1 investments.

Derivatives – currency forward contracts: Consists of currency forward contracts trading with sufficient frequency and volume to enable us to obtain pricing information on an ongoing basis. The fair value of these securities was measured based on a valuation from a third-party bank. See "Note 13. Derivative Financial Instruments" for more information regarding our derivatives.

Contingent liability: Consists of the fair value of a liability measured on expected future payments relating to a business acquisition if future financial performance measures are achieved. The contingent liability was calculated by estimating the discounted present value of expected future payments for estimated performance measure attainment. To estimate future performance measure attainment, we utilized significant unobservable inputs as of July 29, 2017 and April 29, 2017. The unobservable inputs included management expectations and forecasts for business performance and an estimated discount rate based on current borrowing interest rates. To the extent that these assumptions changed or actual results differed from these estimates, the fair value of the contingent consideration liabilities could change. The contingent liability is presented in other long-term obligations in our consolidated balance sheets.

Non-recurring measurements: The fair value measurement standard also applies to certain non-financial assets and liabilities measured at fair value on a nonrecurring basis. Certain long-lived assets such as goodwill, intangible assets and property, plant and equipment are measured at fair value on a nonrecurring basis and are subject to fair value

adjustments in certain circumstances, such as when there is evidence of impairment.

Other measurements using fair value: Some of our financial instruments, such as accounts receivable, long-term receivables, prepaid expense and other assets, costs and earnings in excess of billings and billings in excess of costs, accounts payable, warranty obligations, customer deposits, deferred revenue, and other long-term obligations, are reflected in the balance sheet at carrying value, which approximates fair value due to their short-term nature.

Note 13. Derivative Financial Instruments

We utilize derivative financial instruments to manage the economic impact of fluctuations in currency exchange rates on those transactions denominated in currencies other than our functional currency, which is the U.S. dollar. We enter into currency forward contracts to manage these economic risks. We account for all derivatives on the balance sheet within accounts receivable or accounts payable measured at fair value, and changes in fair values are recognized in earnings unless specific hedge accounting criteria are met for cash flow or net investment hedges. As of July 29, 2017 and April 29, 2017, we had not designated any of our derivative instruments as accounting hedges, and thus we recorded the changes in fair value in other income (expense), net.

The foreign currency exchange contracts in aggregated notional amounts in place to exchange U.S. dollars at July 29, 2017 and April 29, 2017 were as follows:

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	July 29, 2017		April 29, 2017	
	U.S. Dollars	Foreign Currency	U.S. Dollars	Foreign Currency
Foreign Currency Exchange Forward Contracts:				
U.S. Dollars/Australian Dollars	3,632	4,842	7,984	10,669
U.S. Dollars/Canadian Dollars	998	1,319	256	345
U.S. Dollars/British Pounds	3,283	2,633	4,936	3,959
U.S. Dollars/Singapore Dollars	—	—	605	844
U.S. Dollars/Euros	1,688	1,498	528	491

As of July 29, 2017, there was an asset and liability of $31 and $602, respectively, and as of April 29, 2017, there was an asset and liability of $64 and $277, respectively, representing the fair value of foreign currency exchange forward contracts, which were determined using Level 2 inputs from a third-party bank.

Note 14. Subsequent Events

On August 31, 2017, our Board of Directors declared a regular quarterly dividend of $0.07 per share on our common stock payable on September 21, 2017 to holders of record of our common stock on September 11, 2017.

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

FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q (including exhibits and any information incorporated by reference herein) contains both historical and forward-looking statements that involve risks, uncertainties and assumptions. The statements contained in this Report that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21B of the Securities Exchange Act of 1934, as amended, including statements regarding our expectations, beliefs, intentions and strategies for the future. These statements appear in a number of places in this Report and include all statements that are not historical statements of fact regarding the intent, belief or current expectations with respect to, among other things: (i.) our competition; (ii.) our financing plans; (iii.) trends affecting our financial condition or results of operations; (iv.) our growth strategy and operating strategy; (v.) the declaration and payment of dividends; (vi.) the timing and magnitude of future contracts; (vii.) parts shortages and lead times; (viii.) fluctuations in margins; (ix.) the seasonality of our business; (x.) the introduction of new products and technology; (xi.) the amount and frequency of warranty claims; and (xii.) the timing and magnitude of any acquisitions or dispositions. The words "may," "would," "could," "should," "will," "expect," "estimate," "anticipate," "believe," "intend," "plans" and similar expressions and variations thereof are intended to identify forward-looking statements. Investors are cautioned that any such forward-looking statements are not guarantees of future performance and involve risks and uncertainties, many of which are beyond our ability to control, and that actual results may differ materially from those projected in the forward-looking statements as a result of various factors discussed herein, including those discussed in our filings with the Securities and Exchange Commission, including our Annual Report on Form 10-K for the fiscal year ended April 29, 2017 in the section entitled "Item 1A. Risk Factors" and "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations," and those factors discussed in detail in our other filings with the Securities and Exchange Commission.

The following discussion highlights the principal factors impacting our financial condition and further describes our results of operations. This discussion should be read in conjunction with the accompanying Consolidated Financial Statements and Notes to the Consolidated Financial Statements included in this Report.

The following discussion and analysis of financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP"). The preparation of these financial statements requires us to make estimates and judgments affecting the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. On a regular basis, we evaluate our estimates, including those related to total costs on long-term construction-type contracts, costs to be incurred for product warranties and extended maintenance contracts, bad debts, excess and obsolete inventory, income taxes, share-based compensation, goodwill impairment and contingencies. Our estimates are based on historical experience and on various other assumptions believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities not readily apparent from other sources. Actual results may differ from these estimates.

OVERVIEW

We design, manufacture and sell a wide range of display systems to customers throughout the world. We focus our sales and marketing efforts on markets, geographical regions and products. Our five business segments consist of four domestic business units and the International business unit. The four domestic business units consist of Commercial, Live Events, High School Park and Recreation, and Transportation, all of which include the geographic territories of the United States and Canada. Disclosures related to our business segments are provided in "Note 4. Segment

Disclosure" of the Notes to the Consolidated Financial Statements included elsewhere in this Report.

Our net sales and profitability historically have fluctuated due to the impact of large project orders, such as display systems for professional sports facilities, colleges and universities, and spectacular projects in the commercial area, as well as the seasonality of the sports market. Large project orders can include several displays, controllers, and subcontracted structure builds, each of which can occur on varied schedules per the customer's needs. Net sales and gross profit percentages also have fluctuated due to other seasonal factors, including the impact of holidays, which primarily affects our third fiscal quarter.

Our gross margins on large custom and large standard orders tend to fluctuate more than on small standard orders. Large product orders involving competitive bidding and substantial subcontract work for product installation generally have lower gross margins. Although we follow the percentage of completion method of recognizing revenues for large custom orders, we nevertheless have experienced fluctuations in operating results and expect our future results of operations will be subject to similar fluctuations.

Our backlog consists of contractually binding sales agreements or purchase orders we expect to fill within the next 24 months. Orders are booked and included in backlog only upon receipt of an executed contract and any required deposits. As a result, certain orders for

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which we have received binding letters of intent or contracts will not be booked until all required contractual documents and deposits are received. In addition, order bookings can vary significantly on a quarterly basis as a result of the timing of large orders. Because order backlog may be subject to extended delivery schedules, orders may be canceled, and orders have varied estimated profitability, our backlog is not necessarily indicative of future net sales or net income. Backlog can fluctuate due to large order booking timing and seasonality. Backlog is not a measure defined by GAAP, and our methodology for determining backlog may vary from the methodology used by other companies in determining their backlog amounts.

For a summary of recently issued accounting pronouncements and the effects of those pronouncements on our financial results, refer to "Note 1. Basis of Presentation and Summary of Critical Accounting Policies" of the Notes to the Consolidated Financial Statements included elsewhere in this Report.

GENERAL

Our mission is to be the world leader at informing and entertaining audiences through dynamic audio-visual communication systems. We measure our success through estimated market share based on estimated market demand for digital displays and generating profits over the long-term. Our success is contingent on the depth and quality of our products, including related control systems, the depth of our service offerings and our technology serving these market demands. These qualities are important for our long-term success because our products have finite lifetimes, and we strive to win replacement business from existing customers.

Increases in user adoption, the acceptance of a variety of digital solutions, and the decline of digital solution pricing over the years has increased the size of the global market. With this positive demand, strong competition exists across all of our business units, which causes margin constraints. Projects with multi-million dollar revenue potential also attract competition, which generally reduces profitability.

We organize around customer segments and geographic regions as further described in "Note 4. Segment Disclosure" of the Notes to the Consolidated Financial Statements included elsewhere in this Report. Each business segment also has unique key growth drivers and challenges.

Commercial Business Unit: Over the long-term, we believe growth in the Commercial business unit will result from a number of factors, including:

- Standard display product market growth due to market adoption and lower product costs, which drive marketplace expansion. Standard display products are used to attract or communicate with customers and potential customers of retail, commercial, and other establishments. Pricing and economic conditions are the principal factors that impact our success in this business unit. We utilize a reseller network to distribute our standard products.
- National accounts standard display market opportunities due to customers' desire to communicate their message, advertising and content consistently across the country. Increased demand is possible from retailers, quick serve restaurants, petroleum businesses, and other nationwide organizations.
- Increasing interest in spectaculars, which include very large and sometimes highly customized displays as part of entertainment venues such as casinos, shopping centers, cruise ships and Times Square type locations.
- Dynamic messaging systems demand growth due to market adoption and marketplace expansion.
- The use of architectural lighting products for commercial buildings, which real estate owners use to add accents or effects to an entire side or circumference of a building to communicate messages or to decorate the building.
- The continued deployment of digital billboards as OOH companies continue developing new sites and start to replace digital billboards which are reaching end of life. This is dependent on there being no adverse changes in the digital billboard regulatory environment, which could restrict future deployments of billboards, as well as maintaining our

current market share of the business concentrated in a few large OOH companies.
- Replacement cycles within each of these areas.

Live Events Business Unit: Over the long-term, we believe growth in the Live Events business unit will result from a number of factors, including:

- Facilities spending more on larger display systems to enhance the game-day and event experience for attendees.
- Lower product costs, driving an expansion of the marketplace.
- Our product and service offerings, which remain the most integrated and comprehensive offerings in the industry.
- The competitive nature of sports teams, which strive to out-perform their competitors with display systems.
- The desire for high-definition video displays, which typically drives larger displays or higher resolution displays, both of which increase the average transaction size.
- Dynamic messaging systems needs throughout a sports facility.
- Replacement cycles within each of these areas.

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High School Park and Recreation Business Unit: Over the long-term, we believe growth in the High School Park and Recreation business unit will result from a number of factors, including:

- Increased demand for video systems in high schools as school districts realize the revenue generating potential of these displays versus traditional scoreboards.
- Increased demand for different types of displays and dynamic messaging systems, such as message centers at schools to communicate to students, parents and the broader community.
- The use of more sophisticated displays in athletic facilities, such as aquatic venues in schools.

Transportation Business Unit: Over the long-term, we believe growth in the Transportation business unit will result from increasing applications and acceptance of electronic displays to manage transportation systems, including roadway, airport, parking, transit and other applications. Effective use of the United States transportation infrastructure requires intelligent transportation systems. This growth is highly dependent on government spending, primarily by the federal government, along with the continuing acceptance of private/public partnerships as an alternative funding source.

International Business Unit: Over the long-term, we believe growth in the International business unit will result from achieving greater penetration in various geographies and building products more suited to individual markets. We continue to broaden our product offerings into the transportation segment in Europe and the Middle East. We also focus on sports facility, spectacular-type, and third-party advertising market opportunities and the factors listed in each of the other business units to the extent they apply outside the United States and Canada.

Each of our business units is impacted by adverse economic conditions in different ways and to different degrees. The effects of an adverse economy are generally less severe on our sports related business as compared to our other businesses, although in severe economic downturns, the sports business also can be seriously impacted. Our Commercial and International business units are highly dependent on economic conditions in general.

RESULTS OF OPERATIONS

COMPARISON OF THE THREE MONTHS ENDED JULY 29, 2017 AND JULY 30, 2016

Net Sales

(in thousands)	Three Months Ended July 29, 2017	July 30, 2016	Dollar Change	Percent Change
Net sales:				
Commercial	$32,863	$36,254	$(3,391)	(9.4)%
Live Events	77,612	60,633	16,979	28.0
High School Park and Recreation	28,479	27,617	862	3.1
Transportation	18,912	14,286	4,626	32.4
International	14,862	18,356	(3,494)	(19.0)
	$172,728	$157,146	$15,582	9.9 %
Orders:				
Commercial	$29,937	$45,068	$(15,131)	(33.6)%
Live Events	61,605	52,880	8,725	16.5
High School Park and Recreation	32,180	31,113	1,067	3.4
Transportation	9,269	11,915	(2,646)	(22.2)

International	20,090	34,192	(14,102)	(41.2)
	$153,081	$175,168	$(22,087)	(12.6)%

Commercial: The decrease in net sales for the three months ended July 29, 2017 compared to the same period one year ago was primarily due to a decline in the billboard niche market demand, partially offset by an increase in large spectacular projects.

The decrease in orders for the three months ended July 29, 2017 compared to the same period one year ago was the net result of volatility in order timing of large custom projects in the spectacular niche and lower market demand in the billboard niche compared to last year. Comparability of quarter over quarter is difficult due to the uniqueness of the projects in the market.

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Live Events: The increase in net sales for the three months ended July 29, 2017 compared to the same period one year ago was primarily due to continued demand and the timing of the demand for upgraded or new solutions for arenas, professional sports, and colleges and universities.

Orders increased for the three months ended July 29, 2017 compared to the same period one year ago due to increased projects in college and university venues and professional sport arenas.

High School Park and Recreation: The increase in net sales for the three months ended July 29, 2017 compared to the same period one year ago was primarily due to increased shipments of scoring systems and message centers due to increased market activity and timing of customer demand.

Orders increased for the three months ended July 29, 2017 compared to the same period one year ago due to strong market demand for scoring systems and message centers.

Transportation: Net sales for the three months ended July 29, 2017 compared to the same period one year ago increased due to higher demand from state transportation authorities.

Orders for the three months ended July 29, 2017 compared to the same period one year ago decreased primarily due to variability caused by large order timing.

International: Net sales for the three months ended July 29, 2017 compared to the same period one year ago decreased primarily due to lower volume of orders.

Orders decreased for the three months ended July 29, 2017 compared to the same period one year ago primarily due the volatility of large order timing.

Backlog

The product order backlog as of July 29, 2017 was $184 million as compared to $198 million as of July 30, 2016 and $203 million at the end of the fourth quarter of fiscal 2017. Historically, our backlog varies due to the seasonality of our business, the timing of large projects, and customer delivery schedules for these orders. The backlog as of July 29, 2017 increased from July 30, 2016 in our High School Park and Recreation and Transportation business units and decreased in our Commercial, Live Events and International business units.

Gross Profit

	Three Months Ended			
	July 29, 2017		July 30, 2016	
(in thousands)	Amount	As a Percent of Net Sales	Amount	As a Percent of Net Sales
Commercial	$8,268	25.2 %	$9,155	25.3 %
Live Events	17,054	22.0	12,176	20.1
High School Park and Recreation	10,351	36.3	9,460	34.3
Transportation	6,945	36.7	4,842	33.9
International	2,028	13.6	3,434	18.7
	$44,646	25.8 %	$39,067	24.9 %

Gross profit is net sales less cost of goods sold. Cost of goods sold consist primarily of inventory, consumables, salaries, other employee-related costs, facilities-related costs for manufacturing locations, machinery and equipment maintenance and depreciation, site sub-contractors, warranty costs, and other service delivery expenses.

The increase in our gross profit percentage for the three months ended July 29, 2017 compared to the same period one year ago was primarily due to improved performance on large projects as compared to original estimates and improved productivity to achieve higher sales volumes at similar costs. The following describes the overall impact by business unit:

Commercial: The gross profit percent remained relatively flat for the three months ended July 29, 2017 compared to the same period one year ago.

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Live Events: The gross profit percent increase for the three months ended July 29, 2017 compared to the same period one year ago was due to improved performance on large projects as compared to original estimates and improved productivity to achieve higher sales volumes at similar costs, offset by higher warranty expenses as a percent of sales.

High School Park and Recreation: The gross profit percent increase for the three months ended July 29, 2017 as compared to the same period one year ago was primarily due to improved productivity to achieve higher sales volumes on similar costs.

Transportation: The gross profit percent increase for the three months ended July 29, 2017 compared to the same period one year ago was primarily due to an increased volume of sales.

International: The gross profit percent decrease for the three months ended July 29, 2017 compared to the same period one year ago was primarily the result of lower sales volumes over a relatively fixed cost structure and higher warranty expenses as a percent of sales.

Selling Expense

	Three Months Ended					
	July 29, 2017			July 30, 2016		
(in thousands)	Amount	As a Percent of Net Sales	Percent Change	Amount	As a Percent of Net Sales	
Commercial	$4,694	14.3	% 0.8	% $4,659	12.9	%
Live Events	3,318	4.3	0.5	3,302	5.4	
High School Park and Recreation	2,604	9.1	5.9	2,460	8.9	
Transportation	1,037	5.5	(16.4)	1,241	8.7	
International	3,286	22.1	(8.6)	3,597	19.6	
	$14,939	8.6	% (2.1)%	$15,259	9.7	%

Selling expenses consist primarily of salaries, other employee-related costs, travel and entertainment expenses, facilities-related costs for sales and service offices, bad debt expenses, third-party commissions and expenditures for marketing efforts, including the costs of collateral materials, conventions and trade shows, product demos, and supplies.

Selling expense in our High School Park and Recreation business unit increased in the first quarter of fiscal 2018 compared to the same quarter a year ago, which was mainly related to increases in personnel expenses.

Selling expense in our Transportation and International business units declined in the first quarter of fiscal 2018 compared to the same quarter a year ago due to lower personnel related costs, lower bad debt expense and third-party commissions that had been incurred in the first quarter of fiscal 2017.

Selling expense in our Commercial and Live Events business units for the first quarter of fiscal 2018 remained relatively flat compared to the same quarter a year ago.

Other Operating Expenses

	Three Months Ended	
	July 29, 2017	July 30, 2016
	Amount	Amount

(in thousands)		As a Percent of Net Sales	Percent Change		As a Percent of Net Sales
General and administrative	$8,935	5.2 %	1.7 %	$8,783	5.6 %
Product design and development	$9,047	5.2 %	28.5 %	$7,043	4.5 %

General and administrative expenses consist primarily of salaries, other employee-related costs, professional fees, shareholder relations costs, facilities and equipment-related costs for administrative departments, training costs, and the costs of supplies.

General and administrative expenses in the first quarter of fiscal 2018 increased as compared to the same period one year ago primarily due to increases in personnel expenses and information technology software and hardware expenses.

Product design and development expenses consist primarily of salaries, other employee-related costs, professional services, facilities costs and equipment-related costs and supplies. Product development investments in the near term are focused on developing or improving our video technology over a wide range of pixel pitches for both indoor and outdoor applications. These new or improved technologies are focused on varied pixel density for image quality and use, expanded product line offerings for our various markets and geographies,

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improved quality and reliability, and improved cost points. We plan to make continued investments in our software and controller capabilities throughout our varied product offerings. Through all design efforts, we focus on standardizing display components and control systems for both single site and network displays.

Our costs for product development represent an allocated amount of costs based on time charges, professional services, materials costs and the overhead of our engineering departments. Generally, a significant portion of our engineering time is spent on product development, while the rest is allocated to large contract work and is included in cost of goods sold.

Product development expenses in the first quarter of fiscal 2018 increased as compared to the same period one year ago primarily due to increased labor costs and professional services assigned to product development projects relating to our strategy to accelerate the deployment of our products and solutions to the market. To deliver value to our customers and serve the markets' expectations, we plan to increase the level of expenditures for new or enhanced customer solutions as compared to prior years during fiscal 2018.

Other Income and Expenses

	Three Months Ended					
	July 29, 2017			July 30, 2016		
(in thousands)	Amount	As a Percent of Net Sales	Percent Change	Amount	As a Percent of Net Sales	
Interest income, net	$125	0.1 %	(23.3)%	$163	0.1 %	
Other income (expense), net	$145	0.1 %	(254.3)%	$(94)	(0.1)%	

Interest income (expense), net: We generate interest income through short-term cash investments, marketable securities, and product sales on an installment basis or in exchange for the rights to sell and retain advertising revenues from displays, which result in long-term receivables. Interest expense is comprised primarily of interest costs on long-term marketing obligations.

Interest income, net in the first quarter of fiscal 2018 compared to the same period one year ago decreased as a result of lower long-term receivables which bear imputed interest rates. As a result of the volatility of working capital needs and changes in investing and financing activities, along with changes in the interest rate environment, it is difficult to project changes in interest income.

Other income (expense), net: The change in other income and expense, net for the first quarter of fiscal 2018 as compared to the same period one year ago was primarily due to foreign currency volatility and the losses recorded from an equity method affiliate.

Income Taxes

Our effective tax rate was 29.7 percent for the first quarter of fiscal 2018 as compared to an effective tax rate of 31.2 percent for the first quarter of fiscal 2017. The substantial factor impacting our effective rate was due to an increase in our expected research and development tax credit due to an increase in activity within product development.

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LIQUIDITY AND CAPITAL RESOURCES

	Three Months Ended		
(in thousands)	July 29, 2017	July 30, 2016	Percent Change
Net cash (used in) provided by:			
Operating activities	$(4,913)	$6,598	(174.5)%
Investing activities	3,007	2,369	26.9
Financing activities	(3,901)	(7,134)	(45.3)
Effect of exchange rate changes on cash	52	(383)	(113.6)
Net (decrease) increase in cash and cash equivalents	$(5,755)	$1,450	(496.9)%

Net cash provided by operating activities: Operating cash flows consist primarily of net income adjusted for non-cash items including depreciation and amortization, stock-based compensation, deferred income taxes and the effect of changes in operating assets and liabilities.

Net cash used in operating activities was $4.9 million for the first three months of fiscal 2018 compared to net cash provided by operating activities of $6.6 million in the first three months of fiscal 2017. Cash flow from operating activities fluctuated due to a rise in accounts receivable corresponding with the increase in net sales. The $11.5 million decrease in cash from operating activities from the first three months of fiscal 2017 to the first three months of fiscal 2018 was the net result of changes in net operating assets and liabilities of $14.3 million, a $0.1 million decrease in depreciation and amortization, a $0.1 million decrease in other non-cash items, net, adjusted by an increase of $0.1 million equity losses of an affiliate and a $2.9 million increase in net income.

The changes in operating assets and liabilities consisted of the following:

	Three Months Ended	
	July 29, 2017	July 30, 2016
(Increase) decrease:		
Restricted cash	$(6)	$5
Accounts receivable	(22,035)	(8,835)
Long-term receivables	488	432
Inventories	(7,878)	1,098
Costs and estimated earnings in excess of billings	(9,952)	(19,972)
Prepaid expenses and other current assets	696	532
Income tax receivables	295	4,050
Investment in affiliates and other assets	104	(108)
Increase (decrease):		
Current marketing obligations and other payables	(638)	(386)
Accounts payable	4,732	7,169
Customer deposits (billed or collected)	3,904	4,638
Accrued expenses	2,333	2,967
Warranty obligations	507	(1,114)
Billings in excess of costs and estimated earnings	3,739	2,106
Long-term warranty obligations	1,347	534
Income taxes payable	1,644	(1)
Deferred revenue (billed or collected)	1,533	813

Long-term marketing obligations and other payables	601	1,781
	$(18,586)	$(4,291)

Overall, changes in operating assets and liabilities can be impacted by the timing of cash flows on large orders, which can cause significant short-term fluctuations in inventory, accounts receivables, accounts payable, customer deposits, costs and earnings in excess of billings, and various other operating assets and liabilities. Variability in costs and earnings in excess of billings and billings in excess of costs

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relates to the timing of billings on construction-type contracts and revenue recognition, which can vary significantly depending on contractual payment terms and build and installation schedules. Balances are also impacted by the seasonality of the sports markets.

Net cash provided by investing activities: Net cash provided by investing activities totaled $3.0 million in the first three months of fiscal 2018 compared to $2.4 million in the first three months of fiscal 2017. The change in the amount of cash from investing activities was primarily the result of a net increase in the maturities of marketable securities of $3.2 million in the first three months of fiscal 2018 as compared to the first three months of fiscal 2017. Purchases of property and equipment totaled $4.1 million in the first three months of fiscal 2018 compared to $2.2 million in the first three months of fiscal 2017. A cash outlay of $0.6 million was recognized during the first three months of fiscal 2018 for equity investments.

Net cash used in financing activities: Net cash used in financing activities was $3.9 million for the three months ended July 29, 2017 compared to $7.1 million in the same period one year ago. Dividends of $3.1 million, or $0.07 per share, were paid to Daktronics shareholders during the first three months of fiscal 2018, as compared to dividends of $4.4 million, or $0.10 per share, paid to Daktronics shareholders during the first three months of fiscal 2017. In the first quarter of fiscal 2017, we used $1.8 million to purchase our common shares as part of the $40.0 million share repurchase plan authorized by the Board of Directors, and there have been no purchases in the three months ended July 29, 2017.

Other Liquidity and Capital Resources Discussion: We have $10.2 million of retainage on long-term contracts included in receivables and costs in excess of billings as of July 29, 2017, which we expect to collect within one year.

Working capital was $137.2 million and $127.1 million at July 29, 2017 and April 29, 2017, respectively. The changes in working capital, particularly changes in accounts receivable, accounts payable, inventory, and costs in excess of billings and billings in excess of costs, and the seasonality of the sports market can have a significant impact on the amount of net cash provided by operating activities largely due to the timing of payments and receipts. We have historically financed working capital needs through a combination of cash flow from operations and borrowings under bank credit agreements.

We have used and expect to continue to use cash balances to meet our short-term working capital requirements. On large product orders, the time between order acceptance and project completion may extend up to and exceed 24 months depending on the amount of custom work and a customer’s delivery needs. We often receive down payments or progress payments on these product orders. To the extent these payments are not sufficient to fund the costs and other expenses associated with these orders, we use working capital and bank borrowings to finance these cash requirements.

On November 15, 2016, we entered into a credit agreement and a related revolving note with a U.S. bank. The agreement and note have a maturity date of November 15, 2019. The revolving amount of the agreement and note is $35.0 million, including up to $15.0 million for commercial and standby letters of credits. The interest rate ranges from LIBOR plus 145 basis points to LIBOR plus 195 basis points depending on the ratio of our interest-bearing debt to EBITDA. EBITDA is defined as net income before deductions for interest expense, income taxes, depreciation and amortization, all as determined in accordance with U.S. GAAP. The effective interest rate was 2.7 percent at July 29, 2017. We are assessed a loan fee equal to 0.125 percent per annum on any unused portion of the loan. As of July 29, 2017, there were no advances to us under the loan portion of the line of credit, and the balance of letters of credit outstanding was approximately $5.5 million.

The credit agreement is unsecured and requires us to be in compliance with the following financial ratios:

- A minimum fixed charge coverage ratio of at least 2 to 1 at the end of any fiscal year. The ratio is equal to (a) EBITDA less dividends or other distributions (with the exception of any U.S. bank approved special cash dividend), a capital expenditure reserve of $6 million, and income tax expenses paid in cash, but excluding cash used to repurchase any Daktronics, Inc. stock over (b) all principal and interest payments with respect to debt, excluding principal payments on the line of credit; and
- A ratio of interest-bearing debt, excluding any marketing obligations, to EBITDA of less than 1 to 1 at the end of any fiscal quarter.

On November 15, 2016, we entered into an amended and restated loan agreement and a continuing and unlimited guaranty agreement with another U.S. bank which supports our credit needs outside of the United States. The loan and guaranty have a maturity date of November 15, 2019. The revolving amount of the loan is $20.0 million. We intend to use the borrowings under the agreement to support credit needs for general corporate purposes outside the United States. This credit agreement is unsecured. It contains the same covenants as the credit agreement on the line of credit and contains an inter creditor agreement whereby the debt has a cross default provision with the primary credit agreement. Total credit allowed between the two credit agreements is limited to $40.0 million. The interest rate is equal to LIBOR plus 1.5 percent. We are assessed a fixed loan fee of $5 thousand per quarter. As of July 29, 2017, there were no advances outstanding under the loan agreement and approximately $3.4 million in bank guarantees under this line of credit.

As of July 29, 2017, we were in compliance with all applicable bank loan covenants.

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We utilize cash on hand to pay dividends to our investors. The following table summarizes the quarterly dividends declared and paid since the prior fiscal year end of April 29, 2017:

Date Declared	Record Date	Payment Date	Amount per Share
June 1, 2017	June 13, 2017	June 23, 2017	$0.07
August 31, 2017	September 11, 2017	September 22, 2017	$0.07

Although we expect to continue to pay dividends for the foreseeable future, the nature and amounts of dividends will be reviewed regularly and declared by the Board at its discretion.

We are sometimes required to obtain performance bonds for display installations, and we have a bonding line available through a surety company for an aggregate of $150.0 million in bonded work outstanding. If we were unable to complete the work and our customer would call upon the bond for payment, the surety company would subrogate its loss to Daktronics. At July 29, 2017, we had $21.6 million of bonded work outstanding against this line.

Our business growth and profitability improvement strategies depend on investments in capital expenditures. We are projecting capital expenditures to be less than $20 million for fiscal 2018 for purchases of manufacturing equipment for new or enhanced product production, expanded capacity, investments in quality and reliability equipment, and continued information infrastructure investments.

We believe our working capital available from all sources will be adequate to meet the cash requirements of our operations in the foreseeable future. If our growth extends beyond current expectations, profitability does not continue, or if we make any strategic investments, we may need to increase our credit facilities or seek other means of financing. We anticipate we will be able to obtain any needed funds under commercially reasonable terms from our current lenders or other sources, although there can be no guarantee of such.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Foreign Currency Exchange Rates

Through July 29, 2017, most of our net sales were denominated in U.S. dollars, and our exposure to foreign currency exchange rate changes on net sales had not been significant. For the three months ended July 29, 2017, net sales originating outside the United States were 10.8 percent of total net sales, of which a portion was denominated in Canadian dollars, Euros, Chinese renminbi, British pounds, Australian dollars, Brazilian reais or other currencies. We manufacture our products in the United States, China, Belgium, and Ireland. Our results of operations could be affected by factors such as changes in foreign currency rates or weak economic conditions in foreign markets. If we believed currency risk in any foreign location is significant, we would utilize foreign exchange hedging contracts to manage our exposure to the currency fluctuations.

Over the long term, net sales to international markets are expected to increase as a percentage of total net sales and, consequently, a greater portion of our business could be denominated in foreign currencies. In addition, we may fund our foreign subsidiaries' operating cash needs in the form of loans denominated in U.S. dollars. As a result, operating results may become more subject to fluctuations based upon changes in the exchange rates of certain currencies in relation to the U.S. dollar. To the extent we engage in international sales denominated in U.S. dollars, an increase in the value of the U.S. dollar relative to foreign currencies could make our products less competitive in international markets. This effect is also impacted by sources of raw materials from international sources. We estimate that a 10 percent change in all foreign exchange rates would impact our reported income before taxes by approximately $0.5 million. This sensitivity analysis disregards the possibilities that rates can move in opposite directions and that losses from one geographic area may be offset by gains from another geographic area. We will continue to monitor and

minimize our exposure to currency fluctuations and, when appropriate, use financial hedging techniques, including foreign currency forward contracts and options, to minimize the effect of these fluctuations. However, exchange rate fluctuations as well as differing economic conditions, changes in political climates, differing tax structures and other rules and regulations could adversely affect our ability to effectively hedge exchange rate fluctuations in the future.

We have foreign currency forward agreements in place to offset changes in the value of contracts with customers denominated in a foreign currency. The notional amount of these derivatives is $9.6 million, and all contracts mature within 12 months. These contracts are marked to market each balance sheet date and are not designated as hedges. See "Note 13. Derivative Financial Instruments" of the Notes to the Consolidated Financial Statements included elsewhere in this Report for further details.

Interest Rate Risks

Our exposure to market rate risk for changes in interest rates relates primarily to our marketing obligations and long-term accounts receivable. As of July 29, 2017, our outstanding marketing obligations were $0.5 million, all of which were in fixed rate obligations.

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In connection with the sale of certain display systems, we have entered into various types of financing with customers. The aggregate amounts due from customers include an imputed interest element. The majority of these financings carry fixed rates of interest. As of July 29, 2017, our outstanding long-term receivables were $4.4 million. Each 25 basis point increase in interest rates would have an associated immaterial annual opportunity cost.

The following table provides maturities and weighted average interest rates on our financial instruments sensitive to changes in interest rates.

	Fiscal Years (dollars in thousands)					
	2018	2019	2020	2021	2022	Thereafter
Assets:						
Long-term receivables, including current maturities:						
Fixed-rate	$1,746	$1,300	$624	$388	$290	$ 55
Average interest rate	8.9 %	8.8 %	8.7 %	8.6 %	8.4 %	9.0 %
Liabilities:						
Long- and short-term debt:						
Fixed-rate	$156	$530	$1,000	$—	$—	$ —
Average interest rate	5.7 %	4.5 %	3.3 %	— %	— %	— %
Long-term marketing obligations, including current portion:						
Fixed-rate	$189	$198	$99	$10	$—	$ —
Average interest rate	8.4 %	9.0 %	9.0 %	9.0 %	— %	— %

Of our $26.9 million in cash balances at July 29, 2017, $19.6 million were denominated in U.S. dollars. Cash balances in foreign currencies are operating balances maintained in accounts of our foreign subsidiaries. A portion of the cash held in foreign accounts is used to collateralize outstanding bank guarantees issued by our foreign subsidiaries.

Commodity Risk

We are dependent on basic raw materials, sub-assemblies, components, and other supplies used in our operations. Our financial results could be affected by the availability and changes in prices of these materials. Some of these materials are sourced from a limited number of suppliers or only a single supplier. These materials are also key source materials for our competitors. Therefore, if demand for these materials rises, we may experience increased costs and/or limited or unavailable supplies. As a result, we may not be able to acquire key production materials on a timely basis, which could impact our ability to produce products and satisfy incoming sales orders on a timely basis. In addition, the costs of these materials can rise suddenly and result in significantly higher costs of production. Our sourcing group works to implement strategies to mitigate these risks. Periodically, we enter into pricing agreements or purchasing contracts under which we agree to purchase a minimum amount of product in exchange for guaranteed price terms over the length of the contract, which generally does not exceed one year. We believe that we have adequate sources of supply for most of our key materials.

Item 4. CONTROLS AND PROCEDURES

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,” as that term is defined in Rule 13a-15(e) and Rule 15d-15(e) under the Securities Exchange Act of 1934, as of July 29, 2017, which is the end of the period covered by this Report. Based upon that evaluation,

the Chief Executive Officer and Chief Financial Officer concluded that as of July 29, 2017, our disclosure controls and procedures were effective.

Based on the evaluation described in the foregoing paragraph, our Chief Executive Officer and Chief Financial Officer concluded that during the quarter ended July 29, 2017, there was no change in our internal control over financial reporting which has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

Not applicable.

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Item 1A. RISK FACTORS

The discussion of our business and operations included in this Quarterly Report on Form 10-Q should be read together with the risk factors described in Item 1A. of our Annual Report on Form 10-K for the fiscal year ended April 29, 2017. They describe various risks and uncertainties to which we are or may become subject. These risks and uncertainties, together with other factors described elsewhere in this Report, have the potential to affect our business, financial condition, results of operations, cash flows, strategies or prospects in a material and adverse manner. New risks may emerge at any time, and we cannot predict those risks or estimate the extent to which they may affect our financial condition or financial results.

Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Share Repurchases

During the three months ended July 29, 2017, we did not repurchase any shares of our common stock.

Item 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

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Item 4. MINE SAFETY DISCLOSURES

Not applicable.

Item 5. OTHER INFORMATION

Not applicable.

Item 6. EXHIBITS

A list of exhibits required to be filed as part of this report is set forth in the Index of Exhibits, which immediately precedes such exhibits, and is incorporated herein by reference.

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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.

/s/ Sheila M. Anderson
Daktronics, Inc.
Sheila M. Anderson
Chief Financial Officer
(Principal Financial Officer and
Principal Accounting Officer)

Date: September 1, 2017

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Index to Exhibits

Certain of the following exhibits are incorporated by reference from prior filings. The form with which each exhibit was filed and the date of filing are as indicated below; the reports described below are filed as Commission File No. 0-23246 unless otherwise indicated.

3.1	Amended and Restated Articles of Incorporation of the Company (Incorporated by reference to Exhibit 3.1 filed with our Quarterly Report on Form 10-Q on August 30, 2013).
3.2	Amended and Restated Bylaws of the Company (Incorporated by reference to Exhibit 3.4 filed with our Annual Report on Form 10-K on June 12, 2013).
10.1	Credit Agreement dated November 15, 2016 by and between the Company and U.S. Bank National Association (Incorporated by reference to Exhibit 10.1 filed with our Current Report on Form 8-K filed on November 16, 2016).
10.2	Revolving Note dated November 15, 2016 issued by the Company to U.S. Bank National Association (Incorporated by reference to Exhibit 10.2 filed with our Current Report on Form 8-K filed on November 16, 2016).
10.3	Amended and Restated Loan Agreement dated November 15, 2016 by and between the Company and Bank of America, N.A. (Incorporated by reference to Exhibit 10.3 filed with our Current Report on Form 8-K filed on November 16, 2016).
10.4	Continuing and Unconditional Guaranty dated November 15, 2016 by and between the Company and Bank of America, N.A. (Incorporated by reference to Exhibit 10.4 filed with our Current Report on Form 8-K filed on November 16, 2016).

10.5	Amended and Restated Loan Agreement dated May 5, 2017 by and between the Company and Bank of America, N.A. (Incorporated by reference to Exhibit 10.6 filed with our Annual Report on Form 10-K filed on June 9, 2017).
10.6	Daktronics, Inc. 2015 Stock Incentive Plan ("2015 Plan"). (Incorporated by reference to Exhibit A to the Company's Definitive Proxy Statement on Schedule 14A filed on July 14, 2015).
10.7	Form of Restricted Stock Award Agreement under the 2015 Plan (Incorporated by reference to Exhibit 10.2 filed with our Current Report on Form 8-K on September 3, 2015).
10.8	Form of Non-Qualified Stock Option Agreement Terms and Conditions under the 2015 Plan (Incorporated by reference to Exhibit 10.3 filed with our Current Report on Form 8-K on September 3, 2015).
10.9	Form of Incentive Stock Option Terms and Conditions under the 2015 Plan (Incorporated by reference to Exhibit 10.4 filed with our Current Report on Form 8-K on September 3, 2015).
10.10	Form of Restricted Stock Unit Terms and Conditions under the 2015 Plan (Incorporated by reference to Exhibit 10.5 filed with our Current Report on Form 8-K on September 3, 2015).
31.1	Certification of the Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (1)
31.2	

31.1	Certification of the Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (1)
32.1	Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350). (1)
32.2	Certification of the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350). (1)
101	The following financial information from our Quarterly Report on Form 10-Q for the period ended July 29, 2017 formatted in Extensible Business Reporting Language (XBRL): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Operations, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Consolidated Statements of Cash Flows, (v) Notes to Consolidated Financial Statements, and (vii) document and entity information. (1)

(1) Filed herewith electronically.