

CYANOTECH CORP
Form 10-Q
February 09, 2012
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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

x Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For Quarterly Period Ended December 31, 2011

Or

o Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the Transition Period From to

Commission File Number 0-14602

CYANOTECH CORPORATION

(Exact name of registrant as specified in its charter)

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NEVADA
(State or other jurisdiction
of incorporation or organization)

91-1206026
(IRS Employer
Identification Number)

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

(Address of principal executive offices)

(808) 326-1353

(Registrant's telephone number)

Not Applicable

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

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

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

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

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

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

Number of common shares outstanding as of February 09, 2012:

| Title of Class | Shares Outstanding |
|---------------------------------|--------------------|
| Common stock - \$0.02 par value | 5,434,958 |

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CYANOTECH CORPORATION

FORM 10-Q

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CYANOTECH CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

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

(Unaudited)

| | December 31, 2011 | March 31, 2011 |
|--|----------------------|-------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 4,190 | \$ 2,062 |
| Accounts receivable, net of allowance for doubtful accounts of \$52 at December 31, 2011 and \$58 at March 31, 2011 | 2,855 | 2,641 |
| Inventories, net | 3,556 | 3,627 |
| Deferred tax assets | 17 | 17 |
| Prepaid expenses and other assets | 374 | 134 |
| Total current assets | 10,992 | 8,481 |
| Equipment and leasehold improvements, net | 5,416 | 4,557 |
| Deferred tax assets | 535 | 535 |
| Other assets | 291 | 287 |
| Total assets | \$ 17,234 | \$ 13,860 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Current maturities of long-term debt | \$ 234 | \$ 204 |
| Customer deposits | 39 | 115 |
| Accounts payable | 1,194 | 1,054 |
| Accrued expenses | 1,343 | 823 |
| Total current liabilities | 2,810 | 2,196 |
| Long-term debt, excluding current maturities | 457 | 553 |
| Total liabilities | 3,267 | 2,749 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Common stock of \$0.02 par value, shares authorized 7,500,000; 5,434,598 shares issued and outstanding at December 31, 2011 and 5,391,968 shares at March 31, 2011 | 109 | 108 |
| Additional paid-in capital | 28,185 | 27,803 |
| Accumulated deficit | (14,327) | (16,800) |
| Total stockholders' equity | 13,967 | 11,111 |

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| | | | | |
|---|----|--------|----|--------|
| Total liabilities and stockholders equity | \$ | 17,234 | \$ | 13,860 |
|---|----|--------|----|--------|

See accompanying Notes to Condensed Consolidated Financial Statements.

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CYANOTECH CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Dollars in thousands, except per share amounts)

(Unaudited)

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|--|------------------------------------|----------|-----------------------------------|-----------|
| | 2011 | 2010 | 2011 | 2010 |
| NET SALES | \$ 6,706 | \$ 3,919 | \$ 18,645 | \$ 11,609 |
| COST OF SALES | 3,879 | 2,687 | 10,924 | 7,066 |
| Gross profit | 2,827 | 1,232 | 7,721 | 4,543 |
| OPERATING EXPENSES: | | | | |
| General and administrative | 955 | 630 | 3,019 | 2,036 |
| Sales and marketing | 631 | 502 | 1,808 | 1,278 |
| Research and development | 77 | 83 | 237 | 229 |
| Loss on disposal of equipment and leasehold improvements | 1 | | 65 | |
| Total operating expenses | 1,664 | 1,215 | 5,129 | 3,543 |
| Income from operations | 1,163 | 17 | 2,592 | 1,000 |
| Interest expense, net | (14) | (16) | (38) | (54) |
| Income before provision for income taxes | 1,149 | 1 | 2,554 | 946 |
| PROVISION FOR (BENEFIT FROM) INCOME TAXES | 36 | (9) | 81 | 11 |
| NET INCOME | \$ 1,113 | \$ 10 | \$ 2,473 | \$ 935 |
| NET INCOME PER SHARE: | | | | |
| Basic | \$ 0.21 | \$ 0.00 | \$ 0.46 | \$ 0.18 |
| Diluted | \$ 0.20 | \$ 0.00 | \$ 0.45 | \$ 0.17 |
| SHARES USED IN CALCULATION OF NET INCOME PER SHARE: | | | | |
| Basic | 5,424 | 5,392 | 5,406 | 5,340 |
| Diluted | 5,571 | 5,423 | 5,490 | 5,366 |

See accompanying Notes to Condensed Consolidated Financial Statements.

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CYANOTECH CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

| | Nine Months Ended December 31, | |
|---|-----------------------------------|--------|
| | 2011 | 2010 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 2,473 | \$ 935 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Loss on disposal of equipment and leasehold improvements | 65 | |
| Depreciation and amortization | 513 | 424 |
| Amortization of debt issue costs and other assets | 32 | 21 |
| Share based compensation expense | 326 | 44 |
| Reduction of allowance for doubtful accounts | (6) | |
| Net (increase) decrease in assets: | | |
| Accounts receivable | (208) | (596) |
| Inventories | 71 | (423) |
| Prepaid expenses and other assets | (275) | (73) |
| Net increase (decrease) in liabilities: | | |
| Customer deposits | (76) | 48 |
| Accounts payable | 140 | (141) |
| Accrued expenses | 520 | 14 |
| Net cash provided by operating activities | 3,575 | 253 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Investment in equipment and leasehold improvements | (1,438) | (401) |
| Proceeds from return of restricted cash | | 250 |
| Net cash used in investing activities | (1,438) | (151) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from long term debt, net of costs | 95 | |
| Principal payments on long-term debt | (160) | (375) |
| Proceeds from stock options exercised | 56 | 185 |
| Net cash used in financing activities | (9) | (190) |
| Net increase (decrease) in cash and cash equivalents | 2,128 | (88) |
| Cash and cash equivalents at beginning of period | 2,062 | 817 |
| Cash and cash equivalents at end of period | \$ 4,190 | \$ 729 |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION: | | |
| Cash paid during the period for: | | |
| Interest | \$ 30 | \$ 35 |
| Income taxes | \$ 60 | \$ 12 |

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See accompanying Notes to Condensed Consolidated Financial Statements.

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CYANOTECH CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

As of December 31, 2011

(Unaudited)

1. BASIS OF PRESENTATION

The accompanying condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information pursuant to the instructions to Form 10-Q and Regulation S-X. These interim condensed consolidated financial statements are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary to present fairly the Condensed Consolidated Balance Sheets, Condensed Consolidated Statements of Operations, and Condensed Consolidated Statements of Cash Flows for the periods presented in accordance with GAAP. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. The condensed consolidated balance sheet as of March 31, 2011 was derived from the audited financial statements. These condensed consolidated financial statements and notes should be read in conjunction with the Company's consolidated financial statements for the year ended March 31, 2011, contained in the Company's annual report on Form 10-K as filed on June 23, 2011.

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

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

2. INVENTORIES

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

| | December 31, 2011 | March 31, 2011 |
|-------------------|-------------------|----------------|
| | (in thousands) | |
| Raw materials | \$ 599 | \$ 336 |
| Work in process | 264 | 339 |
| Finished goods(1) | 2,481 | 2,787 |

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| | | | | |
|----------|----|-------|----|-------|
| Supplies | | 212 | | 165 |
| | \$ | 3,556 | \$ | 3,627 |

(1) Net of reserve for obsolescence of \$16,000 and \$148,000 at December 31, 2011 and March 31, 2011, respectively.

The Company recognizes abnormal production costs, including fixed cost variances from normal production capacity, as an expense in the period incurred. Approximately \$236,000 and \$652,000 of abnormal production costs were charged to cost of sales for the three and nine months ended December 31, 2011, respectively. Approximately \$360,000 of abnormal production costs were charged to cost of sales for the three and nine months ended December 31, 2010.

3. EQUIPMENT AND LEASEHOLD IMPROVEMENTS

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

| | |
|------------------------|----------------|
| Equipment | 3 to 10 years |
| Furniture and fixtures | 7 years |
| Leasehold improvements | 10 to 20 years |

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Equipment and leasehold improvements consist of the following:

| | December 31, 2011 | March 31, 2011 |
|--|-------------------|----------------|
| | (in thousands) | |
| Equipment(1) | \$ 6,533 | \$ 6,801 |
| Leasehold improvements | 7,398 | 7,367 |
| Furniture and fixtures | 113 | 95 |
| | 14,044 | 14,263 |
| Less accumulated depreciation and amortization | (9,691) | (9,817) |
| Construction-in-progress | 1,063 | 111 |
| Equipment and leasehold improvements, net | \$ 5,416 | \$ 4,557 |

(1) Includes \$97,000 of equipment under capital lease with accumulated amortization of \$34,000 and \$19,000 at December 31, 2011 and March 31, 2011, respectively.

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of such assets may not be recoverable. Recoverability of these assets is measured by a comparison of the carrying amount to forecasted undiscounted future cash flows expected to be generated by the asset. If the carrying amount exceeds its estimated future cash flows, then an impairment charge is recognized to the extent that the carrying amount exceeds the asset's fair value. Management has determined no asset impairment existed as of December 31, 2011 and 2010. The Company recognized a loss on disposal of assets in the amount of \$1,000 and \$65,000 for the three and nine months ended December 31, 2011, respectively. There was no disposal of assets for the three and nine months ended December 31, 2010.

4. ACCRUED EXPENSES

Accrued expenses consist of the following:

| | December 31, 2011 | March 31, 2011 |
|--------------------|-------------------|----------------|
| | (in thousands) | |
| Wages, commissions | \$ 411 | \$ 426 |
| Customer rebates | 43 | 173 |
| Bonuses | 457 | 100 |
| Rent | 201 | 62 |
| Other expenses | 231 | 62 |
| | \$ 1,343 | \$ 823 |

5. LINE OF CREDIT

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The Company has a line of credit agreement with First Hawaiian Bank in the amount of \$350,000 with a maturity date of April 1, 2012. The obligation is secured by the Company's U.S. accounts receivable and bears a variable interest rate based on prime (3.25% at December 31, 2011) plus 2%. There was no outstanding balance as of December 31, 2011 and March 31, 2011, respectively. The credit agreement requires the Company to meet certain financial covenants. The Company was in compliance with these financial covenants at December 31, 2011.

6. LONG-TERM DEBT

Long-term debt consists of the following:

| | December 31, 2011 | | March 31, 2011 | |
|--|-------------------|-------|----------------|-------|
| | (in thousands) | | | |
| Term loans | \$ | 691 | \$ | 757 |
| Less current maturities | | (234) | | (204) |
| Long-term debt, excluding current maturities | \$ | 457 | \$ | 553 |

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Term Loan Agreements

In February 2008, the Company executed a Term Loan Agreement with a lender providing for \$1.1 million in aggregate credit facilities, secured by the Company's assets. The Term Loan has a maturity date of March 1, 2015 and is payable in 84 equal monthly principal payments plus interest. The interest rate under the Term Loan, in the absence of a default under the agreement, is the prime rate in effect as of the close of business on the first day of each calendar quarter, plus 1%. As of December 31, 2011, the prime rate was 3.25%. The balance under this loan was \$545,000 and \$660,000 at December 31, 2011 and March 31, 2011, respectively. The Company is prohibited from declaring any common stock dividends without the lender's prior written consent. The credit agreement requires the Company to meet certain financial covenants. The Company was in compliance with these financial covenants at December 31, 2011.

In March 2009, the Company executed a Term Loan Agreement with John Deere credit providing for \$29,000 in equipment, secured by the equipment financed. The Term Loan has a maturity date of March 25, 2013 and is payable in 48 equal monthly principal payments. The interest rate under this Term Loan is 0%. Imputed interest at a rate of 2% (cash discount offered by seller) has been recorded and will be amortized as interest over the term of the loan. The face value of the term loan is reported in the balance sheets at \$9,000, less the unamortized discount of \$121 at December 31, 2011 and \$15,000, less the unamortized discount of \$1,000 at March 31, 2011.

In January 2010, the Company executed a Term Loan Agreement with John Deere credit providing for \$30,000 in equipment, secured by the equipment financed. The Term Loan has a maturity date of December 28, 2012 and is payable in 36 equal monthly principal payments. The interest rate under this Term Loan is 0%. Imputed interest at a rate of 2% (cash discount offered by seller) has been recorded and will be amortized as interest over the term of the loan. The face value of the term loan is reported in the balance sheets at \$10,000, less the unamortized discount of \$106 at December 31, 2011 and \$17,000, less the unamortized discount of \$1,000 at March 31, 2011.

In June 2011, the Company executed a Term Loan Agreement with John Deere credit providing for \$43,000 in equipment, secured by the equipment financed. The Term Loan has a maturity date of May 25, 2015 and is payable in 48 equal monthly principal payments. The interest rate under this Term Loan is 0%. Imputed interest at a rate of 2% (cash discount offered by seller) has been recorded and will be amortized as interest over the term of the loan. The face value of the term loan is reported in the balance sheets at \$37,000, less the unamortized discount of \$1,264 at December 31, 2011.

In September 2011, the Company executed a Term Loan Agreement with Nissan Motor Acceptance Corporation providing for \$23,000 in equipment, secured by the equipment financed. The Term Loan has a maturity date of September 13, 2016 and is payable in 60 equal monthly principal payments. The interest rate under this Term Loan is 0%. Imputed interest at a rate of 2% (cash discount offered by seller) has been recorded and will be amortized as interest over the term of the loan. The face value of the term loan is reported in the balance sheets at \$21,000, less the unamortized discount of \$1,000 at December 31, 2011.

In December 2011, the Company executed a Term Loan Agreement with John Deere credit providing for \$30,000 in equipment, secured by the equipment financed. The Term Loan has a maturity date of November 25, 2015 and is payable in 48 equal monthly principal payments. The interest rate under this Term Loan is 0%. Imputed interest at a rate of 2% (cash discount offered by seller) has been recorded and will be amortized as interest over the term of the loan. The face value of the term loan is reported in the balance sheets at \$29,000, less the unamortized discount of \$1,138 at December 31, 2011.

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Capital Lease

In March 2010, the Company executed a capital lease agreement with Thermo Fisher Financial providing for \$97,000 in equipment, secured by the equipment financed. The capital lease has a maturity date of March 2013 and is payable in 36 equal monthly payments. The interest rate under this capital lease is 6.6%. The balance under this capital lease was \$43,000 at December 31, 2011 and \$67,000 at March 31, 2011.

Future principal payments under the term loans and capital lease agreement as of December 31, 2011 are as follows:

| Payments Due | (in thousands) | |
|--------------------------|---------------------------|-----|
| Next 12 Months | \$ | 234 |
| Year 2 | | 199 |
| Year 3 | | 196 |
| Year 4 | | 62 |
| Total principal payments | \$ | 691 |

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The Company leases facilities, equipment and land under operating leases expiring through 2026. The land lease provides for contingent rental in excess of minimum rental commitments based on a percentage of the Company's sales. Management has accrued for the estimated contingent rent as of December 31, 2011.

Future minimum lease payments under all non-cancelable operating leases at December 31, 2011 are as follows:

| Payments Due | (in thousands) | |
|------------------------------|-----------------------|-------|
| Next 12 Months | \$ | 306 |
| Year 2 | | 314 |
| Year 3 | | 320 |
| Year 4 | | 280 |
| Year 5 | | 179 |
| Thereafter through 2026 | | 1,332 |
| Total minimum lease payments | \$ | 2,731 |

8. SHARE-BASED COMPENSATION

The Company accounts for transactions under share-based payment arrangements with employees based on fair value. Liability-classified awards are remeasured to fair value at each balance sheet date until the award is settled. The Company currently has no liability-classified awards. Equity-classified awards, including grants of employee stock options, are measured at the grant-date fair value of the award and are not subsequently remeasured unless an award is modified. The cost of share-based awards is recognized in the income statement over the period during which an employee is required to provide the service in exchange for the award, or the vesting period. All of the Company's stock options are service-based awards, and because the Company's stock options are plain vanilla, as defined by the U. S. Securities and Exchange Commission in Staff Accounting Bulletin No. 107, they are reflected only in Stockholders' Equity and Compensation Expense accounts.

Stock Options

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

Under the 2005 Plan, eligible employees and certain independent consultants may be granted options to purchase shares of the Company's common stock. The shares issuable under the 2005 Plan will either be shares of the Company's authorized but previously unissued common stock or shares reacquired by the Company, including shares purchased on the open market. As of December 31, 2011, there were 666,038 shares

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available for grant under the 2005 Plan.

Under the 2004 Directors Plan, upon election to the Board of Directors at an annual stockholders meeting, a newly elected non-employee director will be granted a ten-year option to purchase 6,000 shares of the Company's common stock. Options granted vest and become exercisable six months from the date of grant. In addition, on the date of each annual stockholders meeting, each non-employee director continuing in office is automatically issued 2,000 shares of the Company's common stock, and an additional 2,000 shares to the director serving as Chairman of the Board, non-transferable for six months following the date of grant. As of December 31, 2011, there were 143,123 shares available for grant under the 2004 Directors Plan.

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

| | Authorized | As of December 31, 2011 Available | Outstanding |
|---------------------|------------------|--------------------------------------|------------------|
| 2005 Plan | 2,075,000 | 666,038 | 1,244,886 |
| 2004 Directors Plan | 200,000 | 143,123 | 12,000 |
| 1994 Plan | | | 750 |
| Total | 2,275,000 | 809,161 | 1,257,636 |

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All stock option grants made under the 2005 Plan and the 2004 Directors Plan were at exercise prices no less than the Company's closing common stock price on the date of grant. Options under the 2005 Plan and 2004 Directors Plan were determined by the Board of Directors or the Stock Option and Compensation Committee of the Board in accordance with the provisions of the respective plans. The terms of each option grant include vesting, exercise and other conditions are set forth in a Stock Option Agreement evidencing each grant. No option can have a life in excess of ten (10) years under the respective plan. The Company records compensation expense for employee stock options based on the estimated fair value of the options on the date of grant using the Black-Scholes option-pricing model. The model requires various assumptions, including a risk-free interest rate, the expected term of the options, the expected stock price volatility over the expected term of the options and the expected dividend yield. Compensation expense for employee stock options is recognized ratably over the vesting term which ranges from 6 months to five years. Compensation expense recognized for options issued under the 2005 Plan was \$121,000 and \$289,000 for the three and nine months ended December 31, 2011, respectively. Compensation expense recognized for options issued under the 2005 Plan was \$7,000 and \$23,000 for the three and nine months ended December 31, 2010, respectively. Independent Director compensation expense recognized for options issued under the 2004 Directors Plan was \$6,000 and \$40,000 for the three and nine months ended December 31, 2011, respectively. Independent Director compensation expense recognized for options issued under the 2004 Directors Plan was \$0 and \$21,000 for the three and nine months ended December 31, 2010, respectively. All share-based compensation has been classified as General and Administrative expense.

A summary of option activity under the Company's stock plans for the nine months ended December 31, 2011 is presented below:

| Option Activity | Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
|----------------------------------|-----------|------------------------------------|---|---------------------------------|
| Outstanding at March 31, 2011 | 426,650 | \$ 2.49 | | |
| Granted | 922,516 | 3.87 | | |
| Exercised | (31,430) | \$ 1.80 | | |
| Forfeited | (59,350) | \$ 2.14 | | |
| Expired | (750) | \$ 4.20 | | |
| Outstanding at December 31, 2011 | 1,257,636 | \$ 3.53 | 9.3 years | \$ 4,297,504 |
| Exercisable at December 31, 2011 | 53,270 | \$ 2.36 | 7.5 years | \$ 244,334 |

The aggregate intrinsic value in the table above is before applicable income taxes and represents the excess amount over the exercise price optionees would have received if all options had been exercised on the last business day of the period indicated, based on the Company's closing stock price of \$6.95 for such day.

A summary of the Company's non-vested options for the nine months ended December 31, 2011 is presented below:

| Nonvested Options | Shares | Weighted Average Grant-Date Fair Value |
|--------------------------------|-----------|---|
| Nonvested at March 31, 2011 | 377,040 | \$ 1.87 |
| Granted | 922,516 | 2.78 |
| Vested | (38,180) | 1.43 |
| Forfeited or expired | (57,010) | 1.15 |
| Nonvested at December 31, 2011 | 1,204,366 | \$ 2.51 |

The following table summarizes the weighted average characteristics of outstanding stock options as of December 31, 2011:

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| Range of Exercise Prices | Number of Shares | Outstanding Options | | Exercisable Options | |
|--------------------------|------------------|------------------------|------------------------|---------------------|------------------------|
| | | Remaining Life (Years) | Weighted Average Price | Number of Shares | Weighted Average Price |
| \$ 1.41 - \$3.00 | 123,520 | 7.0 | \$ 1.98 | 39,120 | \$ 1.91 |
| \$ 3.01 - \$4.40 | 1,079,116 | 9.5 | 3.63 | 14,150 | 3.63 |
| \$ 4.41 - \$5.40 | 55,000 | 9.8 | 5.16 | | |
| Total stock options | 1,257,636 | 9.3 | \$ 3.53 | 53,270 | \$ 2.36 |

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There were 55,000 and 922,516 stock options granted during the three and nine months ended December 31, 2011, respectively. No stock options were granted during the three and nine months ended December 31, 2010. The value assumptions related to options granted during the nine months ended December 31, 2011 were as follows:

| | 2011 |
|------------------|------------------|
| Exercise Price: | \$3.58 - 5.40 |
| Volatility: | 56.18 - 78.61% |
| Risk Free Rate: | 0.09 - 2.25% |
| Vesting Period: | 0 - 5 years |
| Forfeiture Rate: | 0 - 16.88% |
| Expected Life | 0.25- 8.25 years |
| Dividend Rate | 0% |

As of December 31, 2011, total unrecognized share-based compensation expense related to all unvested stock options was \$2,253,000, which is expected to be expensed over a weighted average period of 4.6 years.

Warrant

At December 31, 2011 the Company had no warrants outstanding. At December 31, 2010, the Company had a single warrant outstanding which allowed the warrant holder rights to acquire 5,000 shares of the Company's common stock. The warrant was valued at the date of grant and was amortized as premium, but was subsequently deemed to have no value as a result of a reverse split which occurred in a prior year. Accordingly, no expense was recognized during the three and nine months ended December 31, 2011 or 2010. The warrant expired in April 2011.

9. INCOME TAXES

Income taxes are provided on the pretax income in the consolidated financial statements. The tax provision is based on the current quarter activity of the legal entities and jurisdictions in which the Company operates. Tax credits are recognized as a reduction to income taxes in the year the credits are earned, accordingly, the effective tax rate may vary from the customary relationship between income tax expense (benefit) and pretax income. The effective tax rate for the three and nine months ended December 31, 2011 differs from the statutory rate due to utilization of net operating loss carryforwards that have been fully reserved due to the Company's inconsistent taxable income in recent years and uncertainty about taxable income in future years.

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

of limitations, or upon occurrence of other events.

As of December 31, 2011, there was no significant liability for income tax associated with unrecognized tax benefits. The Company recognizes accrued interest related to unrecognized tax benefits as well as any related penalties in interest income or expense in its consolidated condensed statements of operations, which is consistent with the recognition of these items in prior reporting periods.

With few exceptions, the Company is no longer subject to U.S. federal, state, local, and non-U.S. income tax examination by tax authorities for tax years before 2007.

10. EARNINGS PER SHARE

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

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Reconciliations between the numerator and the denominator of the basic and diluted earnings per share computations for the three months ended December 31, 2011 and 2010 are as follows:

| | Three Months Ended December 31, 2011 | | |
|--|---|-------------------------|---------------------|
| | Net Income (Numerator) (in thousands) | Shares (Denominator) | Per Share Amount |
| Basic income per share | \$ 1,113 | 5,424 | \$ 0.21 |
| Effect of dilutive securities Common stock options | | 147 | (0.01) |
| | \$ 1,113 | 5,571 | \$ 0.20 |

| | Three Months Ended December 31, 2010 | | |
|--|---|-------------------------|---------------------|
| | Net Income (Numerator) (in thousands) | Shares (Denominator) | Per Share Amount |
| Basic income per share | | | |
| Effect of dilutive securities Common stock options | \$ 10 | 5,392 | \$ 0.00 |
| Diluted income per share | | 31 | |
| | \$ 10 | 5,423 | \$ 0.00 |

Reconciliations between the numerator and the denominator of the basic and diluted earnings per share computations for the nine months ended December 31, 2011 and 2010 are as follows:

| | Nine Months Ended December 31, 2011 | | |
|--|---|-------------------------|---------------------|
| | Net Income (Numerator) (in thousands) | Shares (Denominator) | Per Share Amount |
| Basic income per share | \$ 2,473 | 5,406 | \$ 0.46 |
| Effect of dilutive securities Common stock options | | 84 | (0.01) |
| Diluted income per share | \$ 2,473 | 5,490 | \$ 0.45 |

| | Nine Months Ended December 31, 2010 | | |
|--|---|-------------------------|---------------------|
| | Net Income (Numerator) (in thousands) | Shares (Denominator) | Per Share Amount |
| Basic income per share | \$ 935 | 5,340 | \$ 0.18 |
| Effect of dilutive securities Common stock options | | 26 | (0.01) |
| Diluted income per share | \$ 935 | 5,366 | \$ 0.17 |

Diluted earnings per share does not include the impact of common stock options totaling 786,756 and 6,750 for the three months ended December 31, 2011 and 2010, respectively, and 1,134,116 and 10,180 for the nine months ended December 31, 2011 and 2010, respectively, as the effect of their inclusion would be anti-dilutive.

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

FORWARD-LOOKING STATEMENTS

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

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

- Statements relating to our business strategy;
- Statements relating to our business objectives; and
- Expectations concerning future operations, profitability, liquidity and financial resources.

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

- The added risks associated with the current local, national and world economic crises, including but not limited to, the volatility of crude oil prices, inflation and currency fluctuations;
- The effects of competition, including locations of competitors and operating and market competition;

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- Demand for the company's products, the quantities and qualities thereof available for sale and levels of customer satisfaction;
- Changes in domestic and/or foreign laws, regulations or standards, affecting nutraceutical products or the Company's methods of operation;
- Environmental restrictions, soil and water conditions, variations in daylight hours and seasonal weather patterns, particularly heavy rain, wind and other hazards;
- Access to available and reasonable financing on a timely basis;
- Changes in laws, including new corporate governance requirements and increased tax rates, regulations or accounting standards, and decisions of courts, regulators and governmental bodies;
- Our dependence on the experience, continuity and competence of our executive officers and other key employees;
- The risk associated with the geographic concentration of the company's business;
- Acts of war, terrorist incidents or natural disasters; and
- Other risks or uncertainties described elsewhere in this Report and in other periodic reports previously and subsequently filed by the Company with the Securities and Exchange Commission.

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Comparisons of selected consolidated statements of operations data as reported herein follow for the periods indicated (dollars in thousands):

| | Three Months Ended | | Change |
|----------------------------------|---------------------------|--------------------------|---------------|
| | December 31, 2011 | December 31, 2010 | |
| Net sales: | | | |
| Spirulina products | \$ 2,087 | \$ 1,799 | 16% |
| Natural astaxanthin products | 4,612 | 2,118 | 118% |
| Other products | 7 | 2 | 250% |
| Total sales, all products | \$ 6,706 | \$ 3,919 | 71% |
| Gross profit | \$ 2,827 | \$ 1,232 | 129% |
| Income from operations | \$ 1,163 | \$ 17 | 6,741% |
| Net income | \$ 1,113 | \$ 10 | 11,030% |

| | Nine Months Ended | | Change |
|----------------------------------|--------------------------|--------------------------|---------------|
| | December 31, 2011 | December 31, 2010 | |
| Net sales: | | | |
| Spirulina products | \$ 6,655 | \$ 5,620 | 18% |
| Natural astaxanthin products | 11,974 | 5,984 | 100% |
| Other products | 16 | 5 | 220% |
| Total sales, all products | \$ 18,645 | \$ 11,609 | 61% |
| Gross profit | \$ 7,721 | \$ 4,543 | 70% |
| Income from operations | \$ 2,592 | \$ 1,000 | 159% |
| Net income | \$ 2,473 | \$ 935 | 164% |

Results of Operations*Third Quarter of Fiscal 2012 Compared to Third Quarter of Fiscal 2011*

Net sales for the three months ended December 31, 2011 were \$6,706,000, a 71% increase from the \$3,919,000 reported for the comparable period a year ago. Spirulina sales increased 16% in the current quarter compared to last year due to an 11% increase in bulk sales and a 24% increase in packaged product sales. As a percentage of sales, spirulina accounted for 31% of total sales in the third quarter of fiscal 2012, compared to 46% for the comparable period a year ago.

Natural astaxanthin product sales increased 118% over the third quarter of the prior year due to a 112% increase in bulk product sales and a 131% increase in packaged product sales. Natural astaxanthin product sales increased to 69% of total sales in the third quarter of fiscal 2012 from 54% of total sales in the third quarter of fiscal 2011. The increase in sales can be attributed to the continued affect of previous media reports on the benefits of astaxanthin and the Company's focus on expanding its presence in the growing consumer market for health and nutritional supplement products.

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International sales were 29% of total sales for the third quarter of fiscal year 2012 and 44% in the third quarter of 2011. The decrease in international sales as a percentage of total sales is due to the \$2,578,000 increase in domestic sales from the same period in the prior year. Major customers are those equaling or exceeding 10% of our sales for the period. There were no customers who had sales equaling or exceeding 10% of sales for the third quarter of 2012 and the comparable period of the prior year.

Gross profit for the three months ended December 31, 2011 and 2010 was \$2,827,000 and \$1,232,000, respectively. The increase of \$1,595,000 is the direct result of increased sales and improved efficiency with regard to astaxanthin production. Gross profit margin, as a percentage of sales, was 42% for the three months ended December 31, 2011, compared to 31% for the comparable period in the prior year.

Variable production costs increased by 27% in the current period compared to one year ago. Increases in labor, nutrients, utilities, supplies and repair and maintenance costs were related to an increase in production levels of 23% for spirulina and 118% for astaxanthin over the same quarter one year ago. Fixed costs have increased approximately 18% primarily due to depreciation expense associated with additions to production equipment and increased rent expense.

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Operating expenses were \$1,664,000 during the three months ended December 31, 2011 compared to \$1,215,000 for the three months ended December 31, 2010, an increase of \$449,000. The increase was due to the following: (i) a \$325,000 increase in general and administrative expense, primarily the result of increased bonus, stock option compensation expense, relocation and severance costs; and (ii) a \$129,000 increase in sales and marketing expense, due primarily to increases in external commissions and new marketing and advertising programs for packaged products. As a percentage of sales, operating expenses in the three months ended December 31, 2011 were 25%, as compared to 31% in the three months ended December 31, 2010.

We recorded income tax expense of \$36,000 related to federal and state taxes for the three months ended December 31, 2011 compared to an income tax benefit of \$9,000 recorded for the comparable prior year period. The company's effective tax rate was 3.55% and 0% for the three months ended December 31, 2011 and 2010, respectively. We do not expect any material U.S. federal income taxes to be recorded for the current fiscal year as a result of available net operating loss carry forwards. We do not expect to be able to utilize any of our state net operating loss carry forwards for the current fiscal year.

Nine Months Ended December 31, 2011 Compared to Nine Months Ended December 31, 2010

Net sales for the nine months ended December 31, 2011 were \$18,645,000, an increase of 61% from sales of \$11,609,000 reported for the comparable period a year ago. The increase in sales over the prior year's nine-month period was the result of an 18% increase in spirulina sales and a 100% increase in natural astaxanthin product sales. Spirulina bulk sales increased 11% while packaged spirulina products increased 32%. Astaxanthin bulk sales increased 94% while packaged astaxanthin product sales increased 116%. As a percentage of sales, spirulina accounted for 36% of total sales for the nine months ended December 31, 2011, compared to 48% for the comparable period a year ago. The increase in sales can be attributed to the continued affect of media reports on the benefits of astaxanthin and the Company's focus on expanding its presence in the growing consumer market for health and nutritional supplement products.

International sales represented 32% of net sales for the nine months ended December 31, 2011 compared to 44% for the same period a year ago. For the nine months ended December 31, 2011, there were no customers with sales equaling or exceeding 10% of our total sales. For the nine months ended December 31, 2010, one customer had sales equal to or greater than 10% of our total sales.

Gross profit for the nine months ended December 31, 2011 and December 31, 2010 was \$7,721,000 and \$4,543,000 respectively. The increase of \$3,178,000 is the direct result of increased sales and improved efficiency with regard to astaxanthin production. Gross profit margin, as a percentage of sales, was 41% for the nine months ended December 31, 2011, compared to 39% for the comparable period in the prior year.

For the nine months ended December 31, 2011, variable production costs increased 26%. Increases in labor, nutrients, utilities, supplies and repair and maintenance costs related to an increase in astaxanthin production levels of 94%, offset by a decrease in spirulina production levels of 8% over the same period one year ago. Fixed costs have increased approximately 20% primarily due to depreciation expense associated with additions to production equipment and increased rent expense

Operating expenses for the nine months ended December 31, 2011 were \$5,129,000, an increase of \$1,586,000 or 45% from the comparable prior year period. This increase was due to the following: (i) a \$983,000 increase in general and administrative expense, primarily the result of increased bonus (\$262,000), stock option compensation expense (\$273,000), recruiting, relocation and severance costs; and (ii) an increase of

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\$530,000 in sales and marketing expenses, due primarily to external commissions (\$224,000) and new marketing and advertising programs for packaged products designed to expand consumer awareness (\$171,000).

For the nine months ended December 31, 2011, we recorded income tax expense of \$81,000 related to federal and state taxes, compared to \$11,000 for the nine months ended December 31, 2010. The company's effective tax rate was 3.42% and 1.19% for the nine months ended December 31, 2011 and 2010, respectively. We do not expect any material U.S. federal income taxes to be recorded for the current fiscal year because of available net operating loss carry forwards. We do not expect to be able to utilize any of our state net operating loss carry forwards for the current fiscal year.

Variability of Results

We have experienced significant quarterly fluctuations in operating results and such fluctuations could occur in future periods. We have, during our history, experienced fluctuations in operating results due to the following: changes in sales levels to our customers; competition including pricing, new products and shifts in market trends; production difficulties from environmental influences; increased production costs and variable production results due to inclement weather; and start up costs associated with new product introductions, new facilities and expansion into new markets. In addition, future operating results may fluctuate as a result of factors beyond our control such as foreign exchange fluctuations, changes in government regulations, and economic changes in the

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regions we have customers. A portion of our operating expenses are relatively fixed and the timing of increases in expense levels is based in large part on forecasts of future sales. Therefore, if net sales are below expectations in any given period, the adverse impact on results of operations may be magnified by our inability to effectively adjust spending in certain areas, or to adjust spending in a timely manner, as in personnel and administrative costs. We may also choose to reduce prices or increase spending in response to market conditions, and these decisions may have a material adverse effect on financial condition and results of operations.

Financial Condition

Cash and cash equivalents increased by \$2,128,000, or 103% from March 31, 2011 to \$4,190,000 at December 31, 2011. Cash provided by operating activities of \$3,575,000 increased \$3,322,000 from the same nine month period of last fiscal year. The increase is due to the increase in net income of \$1,538,000, plus the increase of non-cash expenses of \$441,000 and the net change in working capital providing cash of \$1,343,000 over the same nine month period of last fiscal year.

As of December 31, 2011, our accounts receivable, net increased \$214,000 to \$2,855,000 from \$2,641,000 as of March 31, 2011. The increase in accounts receivable is primarily the result of the timing of sales to some large bulk customers for the quarter. Management believes that its accounts receivable are collectible, net of the allowance for doubtful accounts of \$52,000 at December 31, 2011.

Our net inventory decreased \$71,000 or 2% to \$3,556,000 as of December 31, 2011 compared to \$3,627,000 as of March 31, 2011. The decrease in inventory during the first nine months of fiscal 2012 is primarily due to the increase in sales.

Total current liabilities increased \$614,000 or 28% to \$2,810,000 as of December 31, 2011 compared to \$2,196,000 as of March 31, 2011. The increase is mainly due to increased vendor activity in support of the higher sales volume and higher bonus accrual.

Net cash used in investing activities increased by \$1,285,000 over the same nine month period of last fiscal year primarily due to the completion of improvements and acquisition of property plant and equipment, and the return of restricted cash in the amount of \$250,000 that occurred in the prior year. Cash flows used in investing activities reflect capital expenditures which totaled \$1,436,000 during the first nine months of fiscal 2012 compared to \$401,000 one year ago.

Cash flows used in financing activities are attributable to debt payments during that period which were \$160,000 and \$375,000 for the first nine months of fiscal 2012 and 2011, respectively.

Liquidity and Capital Resources

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At December 31, 2011, our working capital was \$8,182,000, an increase of \$1,897,000 compared to \$6,285,000 at March 31, 2011. The increase in working capital is primarily due to the increase in cash, offset by an increase in current liabilities. Cash and cash equivalents at December 31, 2011 totaled \$4,190,000, an increase of \$2,128,000 from \$2,062,000 at March 31, 2011.

The Company has a Term Loan with a lender providing up to \$1.1 million in credit, which is secured by substantially all the assets of the Company. The outstanding balance under the Term Loan as of December 31, 2011 is approximately \$545,000 with a maturity date of March 1, 2015 and is payable in equal monthly principal payments plus interest totaling approximately \$15,000. The interest rate under the Term Loan, in absence of a default under the agreement, is the prime rate, as defined, in effect as of the close of business on the first day of each calendar quarter, plus 1% (the prime rate was 3.25% at December 31, 2011). We are prohibited by the Term Loan from declaring any common stock dividends without the lender's prior written consent.

The Company has a line of credit agreement with First Hawaiian Bank in the amount of \$350,000 with a maturity date of April 1, 2012. The obligation is secured by the Company's U.S. accounts receivable and bears a variable interest rate based on prime (3.25% at December 31, 2011) plus 2%. There was no outstanding balance as of December 31, 2011 and March 31, 2011, respectively. The credit agreement requires the Company to meet certain financial covenants. The Company was in compliance with these financial covenants at December 31, 2011.

We have, as previously reported, experienced a number of factors that have negatively impacted our balance sheet and liquidity. At December 31, 2011, we had an accumulated deficit of \$14,327,000 compared to an accumulated deficit of \$16,800,000 at March 31, 2011. The accumulated deficit decreased by \$2,473,000 for the nine months ended December 31, 2011.

For the remainder of fiscal 2012, we expect to spend approximately \$600,000 in capital expenditures, consisting primarily of operating equipment and building improvements.

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Sufficiency of Liquidity

Based upon our current operating plan, analysis of our consolidated financial position and projected future results of operations, we believe that our operating cash flows, cash balances, and working capital, together with a moderate amount of additional borrowing, will be sufficient to finance current operating requirements, debt service requirements, and planned capital expenditures, for the next twelve (12) months. We expect liquidity in the remainder of fiscal 2012 to be generated from operating cash flows.

Outlook

This outlook section contains a number of forward-looking statements, all of which are based on current expectations. Actual results may differ materially.

Our strategic direction has been to position the Company as a world leader in the production and marketing of high-value natural products from microalgae. We are vertically aligned, producing raw materials in the form of microalgae processed at our 90-acre facility in Hawaii, and integrating those raw materials into finished products. In fiscal 2012, our primary focus has been to put a scalable foundation in place, improving our processes, systems, facilities and organization. We will continue putting increased emphasis on our Nutrex Hawaii consumer products to introduce them to a broader consumer market than in prior years. Our focus going forward will continue to be to leverage our experience and reputation for quality, building nutritional brands which promote health and well-being. The foundation of our nutritional products is naturally cultivated Hawaiian Spirulina Pacifica® in powder and tablet form; and BioAstin® Hawaiian Astaxanthin antioxidant in extract, softgel caplet and micro-encapsulated beadlet form. Responding to the increased market demand of astaxanthin products, the Company announced that it will be increasing its astaxanthin production capacity by 33%. The project is expected to be fully on line during April 2012. Information about our Company and our products can be viewed at www.cyanotech.com and www.nutrex-hawaii.com. Consumer products can also be purchased online at www.nutrex-hawaii.com.

We are focused on sustainability of production levels in order to promote growth in our astaxanthin and spirulina product lines. We will continue to improve and expand this line to meet the demand of consumers. Cyanotech filed a New Dietary Ingredient (NDI) notice with the US FDA to allow a 12 mg dosage of BioAstin Natural Astaxanthin to cover the broad spectrum of potential users. The NDI was reviewed by the FDA without comment and Cyanotech's BioAstin® Natural Astaxanthin is now permitted at 12 mg per day. This compares to other brands whose allowed levels range from 4 mg – 7.8 mg per daily serving. The Company has now introduced a new 12 mg BioAstin softgel capsule which is available as a bulk gelcap product and as a finished consumer product through Nutrex Hawaii. We will continue to promote the nutritional superiority of Hawaiian grown spirulina to maintain and expand market share. Significant sales variability between periods and even across several periods can be expected based on historical results.

Rising crude oil prices in prior years resulted in increased nutrient, utility and transportation costs which reflect and respond to oil prices. We feel that these conditions are likely to continue and/or reoccur from time to time in the future, and consequently, we are putting greater focus on prudent cost controls and expense avoidance.

Gross profit margin percentages going forward will be impacted by continued pressure on input costs and greater competition in the market place. This could cause margins to decline in future periods. We will continue to focus on health and well-being, promoting higher gross margin

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items. We are dedicated to continuous improvements in process and production methods to stabilize and increase production levels for the future.

Producing the highest quality microalgae is a complex biological process which requires balancing numerous factors including microalgal strain variation, temperature, acidity, nutrient and other environmental considerations, some of which are not within our control. An imbalance or unexpected event can occur resulting in production levels below normal capacity. The allocation of fixed production overheads (such as depreciation, rent and general insurance) to inventories is determined based on normal production capacity. When our production volumes are below normal capacity limits, certain fixed production overhead costs cannot be inventoried and are recorded immediately in cost of sales. In addition, when production costs exceed historical averages, we evaluate whether such costs are one-time-period charges or an ongoing component of inventory cost.

To manage our cash resources effectively, we will continue to balance production in light of sales demand, minimizing the cost associated with build-ups in inventory when appropriate. We could experience unplanned cash outflows and may need to utilize other cash resources to meet working capital needs. A prolonged downturn in sales could impair our ability to generate sufficient cash for operations and minimize our ability to attract additional capital investment which could become necessary in order to expand facilities, enter into new markets or maintain optimal production levels.

Our future results of operations and the other forward-looking statements contained in this Outlook, in particular the statements regarding revenues, gross margin and capital spending, involve a number of risks and uncertainties. In addition to the factors discussed above, any of the following could cause actual results to differ materially: business conditions and growth in the natural products industry and in the general economy; changes in customer order patterns; changes in demand for natural products in general; changes in weather conditions; competitive factors, such as increased production capacity from competing spirulina and astaxanthin producers and the resulting impact, if any, on world market prices for these products; government actions and increased regulations both domestic and foreign; shortage of manufacturing capacity; and other factors beyond our control. Risk factors are discussed in detail in Item 1A in our Form 10-K report for the year ended March 31, 2011.

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We believe that our technology, systems, processes and favorable growing location generally permit year-round harvest of our microalgal products in a cost-effective manner. However, previously experienced imbalances in the highly complex biological production systems, together with volatile energy costs and rapidly changing world markets, suggest a need for continuing caution with respect to variables beyond our reasonable control. Therefore, we cannot, and do not attempt to, provide any definitive assurance with regard to our technology, systems, processes, location, or cost-effectiveness.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

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

Item 4. Controls and Procedures

(a) Disclosure Controls and Procedures

We maintain disclosure controls and procedures (as defined in Rules 13a-15(e) and 15 (d)-15(e) under the Exchange Act that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Security and Exchange Commission's rules and forms, and that such information is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. Our management, with the participation of the Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the fiscal period covered by this Quarterly Report on Form 10-Q. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that, as of such date, our disclosure controls and procedures were effective to meet the objective for which they were designed and operate at the reasonable assurance level.

This Form 10-Q should be read in conjunction with Item 9A Controls and Procedures of the Company's Form 10-K for the fiscal year ended March 31, 2011, filed June 23, 2011.

As noted in prior years' Forms 10-K, errors were identified in the calculations and applications of certain accounting practices relating to the carrying value of inventory. Throughout the years subsequent to the identification of the weakness, management has continuously added measures to improve and evaluate the effectiveness of controls over financial reporting. These measures include: upgrades and improvements to the Company's resource management system; automation of manual functions within the resource management system, through the use of interfacing add-on applications and through software application that manage critical data independently; subscription to an online knowledgebase to provide the latest updates and checklists of accounting and reporting standards; additional accounting personnel and system training. Based on these measures, management believes systems and procedures are in place and effective to reasonably ensure accurate financial data as of December 31, 2011.

(b) Changes to Internal Control Over Financial Reporting

We automated several key processes related to the valuation of inventory in order to address the material weakness identified in the prior years, we are continuously making changes in our accounting procedures and processes. These changes, designed to improve our internal controls, relate to proper accounting for inventory costs in accordance with GAAP and with internal control over financial reporting. Accordingly, judgments and separate manual analyses are required to properly allocate costs to inventory and will likely continue to be required.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

None.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

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Item 3. Defaults upon Senior Securities

None.

Item 5. Other Information

None.

Item 6. Exhibits

a) The following exhibits are furnished with this report:

- | | |
|------|---|
| 31.1 | Certifications of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 signed as of February 9, 2012. |
| 31.2 | Certifications of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 signed as of February 9, 2012. |
| 32 | Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 signed as of February 9, 2012. |
| 101 | The following financial statements from Cyanotech Corporation's Quarterly Report on Form 10-Q for the quarter ended December 31, 2011, formatted in XBRL (eXtensible Business Reporting Language): (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Operations, (iii) the Condensed Consolidated Statements of Cash Flows, and (iv) Notes to Condensed Consolidated Financial Statements. |

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SIGNATURES

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

CYANOTECH CORPORATION
(Registrant)

February 9, 2012
(Date)

By:

/s/ Brent D. Bailey
Brent D. Bailey
President and Chief Executive Officer and Director

February 9, 2012
(Date)

By:

/s/ Jole Deal
Jole Deal
*Vice President Finance & Administration and CFO
(Principal Financial and Accounting Officer)*

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EXHIBIT INDEX

| Exhibit Number | Description |
|-----------------------|---|
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