

MAGELLAN PETROLEUM CORP /DE/
Form 10-Q/A
October 23, 2008

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
(Amendment No. 1)
FORM 10-Q/A**

(MARK ONE)

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

For the quarterly period ended December 31, 2007

**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 1-5507
MAGELLAN PETROLEUM CORPORATION
(Exact name of registrant as specified in its charter)

DELAWARE
(State or other jurisdiction of incorporation or
organization)

06-0842255
(I.R.S. Employer Identification No.)

10 Columbus Boulevard, Hartford, Connecticut
(Address of principal executive offices)

06106
(Zip Code)

(860) 293-2006
(Registrant's telephone number, including area code)

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

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

The number of shares outstanding of the issuer's single class of common stock as of February 07, 2008 was 41,500,325.

MAGELLAN PETROLEUM CORPORATION
 FORM 10-Q/A
 December 31, 2007
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IMPORTANT INFORMATION REGARDING THIS FORM 10-Q/A

Explanatory Note

This Amendment No. 1 to our Quarterly Report on Form 10-Q for the period ended December 31, 2007 is being filed solely to provide revised disclosure regarding the Company's recording of depletion expense in 1) the financial statement and related footnotes, 2) management's discussion and analysis of financial condition and results of operations, and 3) quantitative and qualitative disclosure about market risk.

As discussed in Note 8 to the accompanying consolidated financial statements in Item 1 of this quarterly report on Form 10-Q/A, subsequent to the issuance of the Company's Form 10-Q for the period ended December 31, 2007, the Company's management determined that depletion expense was miscalculated due to the misapplication of reserve information for a group of new wells which principally began production in fiscal 2008. Depletion expense for the three and six-month periods ended December 31, 2007 was understated by \$1,569,466 and \$2,816,574, respectively. The restatement has no impact on the consolidated cash flows from operations or cash and cash equivalent balances for the period presented in this Form 10-Q/A. The effects of the restatement on the previously reported Consolidated Statements of Operations for the three and six months ended December 31, 2007, Consolidated Balance Sheet as of December 31, 2007 and Consolidated Statement of Cash Flows for the six months ended December 31, 2007 are presented in Note 8.

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For the convenience of the reader, this Form 10-Q/A sets forth the entire Form 10-Q. However, this Form 10-Q/A amends and restates only portions of Part I, Items 1, 2, 3 and 4. No other Items of the filing have been amended or revised. In addition, no information in this Form 10-Q/A has been updated for any subsequent events occurring after February 13, 2008, the date of the original filing.

MAGELLAN PETROLEUM CORPORATION
FORM 10-Q/A

PART I FINANCIAL INFORMATION

ITEM 1 FINANCIAL STATEMENTS

CONDENSED CONSOLIDATED BALANCE SHEETS

	December 31, 2007 (UNAUDITED) (As Restated, See Note 8)	JUNE 30, 2007 (NOTE)
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 30,232,678	\$ 28,470,448
Accounts receivable Trade (net of allowance for doubtful accounts of \$81,500 and \$69,658 at December 31 and June 30, 2007, respectively)	8,620,669	5,044,258
Accounts receivable-working interest partners	350,269	
Marketable securities	2,404,507	2,974,280
Inventories	1,096,024	702,356
Other assets	260,832	378,808
 Total current assets	 42,964,979	 37,570,150
Deferred income taxes	2,130,501	2,300,830
Marketable securities	1,000,000	1,403,987
Property and equipment, net:		
Oil and gas properties (successful efforts method)	126,296,515	120,734,449
Land, buildings and equipment	2,983,336	2,846,433
Field equipment	948,532	912,396
	130,228,383	124,493,278
Less accumulated depletion, depreciation and amortization	(96,232,203)	(84,172,522)
 Net property and equipment	 33,996,180	 40,320,756
 Goodwill	 4,020,706	 4,020,706
 Total assets	 \$ 84,112,366	 \$ 85,616,429
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 2,425,177	\$ 5,313,653
Accounts payable-working interest partners		222,883
Accrued liabilities	1,566,905	1,382,320
Income taxes payable	12,068,510	1,647,137
 Total current liabilities	 16,060,592	 8,565,993

Long term liabilities:		
Deferred income taxes	2,927,294	3,518,990
Other long term liabilities	39,593	100,578
Asset retirement obligations	10,222,099	9,456,088
Total long term liabilities	13,188,986	13,075,656
Commitments		
Stockholders' equity:		
Common stock, par value \$.01 per share:		
Authorized 200,000,000 shares, outstanding 41,500,325	415,001	415,001
Capital in excess of par value	73,153,002	73,153,002
Accumulated deficit	(25,220,404)	(13,965,849)
Accumulated other comprehensive income	6,515,189	4,372,626
Total stockholders' equity	54,862,788	63,974,780
Total liabilities and stockholders' equity	\$ 84,112,366	\$ 85,616,429

Note: The balance sheet at June 30, 2007 has been derived from the audited consolidated financial statements at that date.

See accompanying notes.

MAGELLAN PETROLEUM CORPORATION
FORM 10-Q/A

PART I FINANCIAL INFORMATION

ITEM 1 FINANCIAL STATEMENTS

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

	THREE MONTHS ENDED		SIX MONTHS ENDED	
	DECEMBER 31,		DECEMBER 31,	
	2007	2006	2007	2006
	(As restated, see Note 8)		(As restated, see Note 8)	
REVENUES:				
Oil sales	\$ 4,887,721	\$ 3,227,393	\$ 9,620,541	\$ 6,152,907
Gas sales	4,772,980	4,490,952	8,762,164	7,894,350
Other production related revenues	713,280	695,740	1,313,209	1,189,992
Total revenues	10,373,981	8,414,085	19,695,914	15,237,249
COSTS AND EXPENSES:				
Production costs	2,525,231	1,806,267	4,623,257	3,597,406
Exploration and dry hole costs	724,117	2,541,280	2,737,591	2,973,263
Salaries and employee benefits	375,840	394,972	820,349	710,102
Depletion, depreciation and amortization	4,365,856	2,762,867	8,774,220	4,764,819
Auditing, accounting and legal services	321,052	148,204	558,103	324,009
Accretion expense	176,180	134,413	346,388	266,179
Shareholder communications	154,222	159,342	201,288	235,890
Gain on sale of field equipment	(17,304)		(26,957)	
Other administrative expenses	771,732	644,969	1,641,645	1,167,581
Total costs and expenses	9,396,926	8,592,314	19,675,884	14,039,249
Operating income (loss)	977,055	(178,229)	20,030	1,198,000
Interest income	569,862	425,793	1,059,079	770,913
Income before income taxes	1,546,917	247,564	1,079,109	1,968,913
Income tax provision	(12,327,026)	(255,471)	(12,333,664)	(946,684)
NET (LOSS) INCOME	(10,780,109)	(7,907)	(11,254,555)	1,022,229
Average number of shares outstanding				
Basic	41,500,325	41,500,325	41,500,325	41,500,325
Diluted	41,500,325	41,500,325	41,500,325	41,500,325
NET (LOSS) INCOME PER SHARE (BASIC AND DILUTED)	\$ (0.26)	\$ (0.00)	\$ (0.27)	\$ 0.02

See accompanying notes

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MAGELLAN PETROLEUM CORPORATION
FORM 10-Q/A
PART I FINANCIAL INFORMATION

ITEM 1 FINANCIAL STATEMENTS

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

	SIX MONTHS ENDED	
	DECEMBER 31,	
	2007	2006
	(As restated, see Note 8)	
OPERATING ACTIVITIES:		
Net (loss) income	\$ (11,254,555)	\$ 1,022,229
Adjustments to reconcile net loss to net cash provided by operating activities:		
Gain from sale of field equipment	(26,957)	
Depletion, depreciation and amortization	8,774,220	4,764,819
Accretion expense	346,388	266,179
Deferred income taxes	(324,744)	1,180,020
Stock option expense		4,950
Exploration and dry hole costs	2,685,371	2,861,197
Increase (decrease) in operating assets and liabilities:		
Accounts receivable	(3,290,960)	(1,234,337)
Other assets	117,976	61,748
Inventories	(358,054)	26,709
Accounts payable and accrued liabilities	(3,376,192)	(600,474)
Income taxes payable	10,360,482	(469,226)
Net cash provided by operating activities	3,652,975	7,883,814
INVESTING ACTIVITIES:		
Proceeds from sale of field equipment	26,957	
Additions to property and equipment	(1,401,692)	(429,874)
Oil and gas exploration activities	(2,685,371)	(2,861,197)
Marketable securities matured	1,474,988	539,675
Marketable securities purchased	(501,228)	(385,347)
Net cash used in investing activities	(3,086,346)	(3,136,743)
FINANCING ACTIVITIES:		
Net cash used in financing activities		
Effect of exchange rate changes on cash and cash equivalents	1,195,601	2,422,556
Net increase in cash and cash equivalents	1,762,230	7,169,627
Cash and cash equivalents at beginning of period	28,470,448	21,882,882
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 30,232,678	\$ 29,052,509

Cash Payments:

Income taxes	2,297,926	487,312
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Interest

Supplemental Schedule of Non-cash Investing and Financing Activities:

At December 31, 2007 and 2006, accounts payable included \$1,654,587 and \$2,696,030 of payables related to property and equipment. A revision to estimates of asset retirement obligations for \$42,882 was made at December 31, 2007.

See accompanying notes.

MAGELLAN PETROLEUM CORPORATION
FORM 10-Q/A

PART I FINANCIAL INFORMATION

ITEM 1 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Basis of Presentation

Magellan Petroleum Corporation (the Company or MPC) is engaged in the sale of oil and gas and the exploration for and development of oil and gas reserves. MPC's principal asset is a 100% equity interest in its subsidiary, Magellan Petroleum Australia Limited (MPAL). MPAL's major assets are two petroleum production leases covering the Mereenie oil and gas field (35% working interest), one petroleum production lease covering the Palm Valley gas field (52% working interest), and three petroleum production leases covering the Nockatunga oil field (41% working interest). Both the Mereenie and Palm Valley fields are located in the Amadeus Basin in the Northern Territory of Australia. The Nockatunga field is located in the Cooper Basin in South Australia. The Palm Valley Darwin contract expires in January, 2012 and the Mereenie contracts expire in June, 2009. MPC has a direct 2.67% carried interest in the Kotaneelee gas field in the Yukon Territory of Canada.

The accompanying unaudited condensed consolidated financial statements include the accounts of MPC and MPAL, collectively the Company, and have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. All such adjustments are of a normal recurring nature. Operating results for the three and six months ended December 31, 2007 are not necessarily indicative of the results that may be expected for the year ending June 30, 2008. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended June 30, 2007. All amounts presented are in United States dollars, unless otherwise noted.

Certain reclassifications of prior period data included in the accompanying consolidated financial statements have been made to conform with current financial statement presentation. An increase in construction payables of \$1,830,464 for the six months ended December 31, 2006 has been reclassified to additions to property and equipment on the consolidated statements of cash flows. This reclassification did not impact previously reported subtotals for operating, investing or financing cash flows.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157, Fair Value Measurements (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. SFAS 157 is effective for the Company beginning July 1, 2008. The Company is currently evaluating the impact, if any, the adoption of SFAS 157 will have on its consolidated financial position, results of operations and cash flows.

In February 2007, the FASB issued SFAS No. 159 The Fair Value Option for Financial Assets and Financial Liabilities, (SFAS 159). SFAS 159 provides companies with an option to report selected financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings at each subsequent reporting date. SFAS 159 is effective for the Company beginning July 1, 2008. The Company is currently in the process of evaluating the impact of adopting SFAS 159 on its consolidated financial statements.

Note 2. Comprehensive Income (Loss)

Total comprehensive income (loss) during the three and six month periods ended December 31, 2007 and 2006 was as follows:

	THREE MONTHS				ACCUMULATED
	ENDED		SIX MONTHS ENDED		OTHER
	DECEMBER 31,		DECEMBER 31,		COMPREHENSIVE
	2007	2006	2007	2006	(INCOME)LOSS
Balance at June 30, 2007					\$ 4,372,626
Net (loss) income	\$ (10,780,109)	\$ (7,907)	\$ (11,254,555)	\$ 1,022,229	
Foreign currency translation adjustments	(162,924)	2,510,633	2,142,563	3,786,588	2,142,563
Total comprehensive (loss) income	\$ (10,943,033)	\$ 2,502,726	\$ (9,111,992)	\$ 4,808,817	
Balance at December 31, 2007					\$ 6,515,189

Note 3. Earnings (Loss) per Share

Earnings per common share are based upon the weighted average number of common and common equivalent shares outstanding during the period. The only reconciling item in the calculation of diluted EPS is the dilutive effect of stock options which were computed using the treasury stock method. During the three and six month periods ended December 31, 2007 and 2006, the Company did not issue any stock options. At December 31, 2007 and 2006, the Company did not have any stock options that were issued that had a stock price below the average stock price for the period. Accordingly, there were no other potentially dilutive items at December 31, 2007 and 2006.

Note 4. Segment Information

The Company has two reportable segments, MPC and its wholly owned subsidiary, MPAL. The Company's chief operating decision maker is Daniel J. Samela (President, Chief Executive Officer and Chief Accounting and Financial Officer) who reviews the results of the MPC and MPAL businesses on a regular basis. MPC and MPAL both engage in business activities from which it may earn revenues and incur expenses. MPAL and its subsidiaries are considered one segment. Although there is discreet information available below the MPAL level, their products and services, production processes, market distribution and customers are similar in nature. In addition, MPAL has a management team which focuses on drilling efforts, capital expenditures and other operational activities.

Segment information (in thousands) for the Company's two operating segments is as follows:

	THREE MONTHS		SIX MONTHS	
	ENDED		ENDED	
	DECEMBER 31,		DECEMBER 31,	
	2007	2006	2007	2006
Revenues:				
MPC	\$ 31	\$	\$ 91	\$ 1
MPAL	10,343	8,414	19,605	15,236
Total consolidated revenues	\$ 10,374	\$ 8,414	\$ 19,696	\$ 15,237
Net (loss) income:				
MPC	\$ (655)	\$ (432)	\$ (1,144)	\$ (855)
MPAL	(10,125)	424	(10,111)	1,877
Consolidated net (loss) income	\$ (10,780)	\$ (8)	\$ (11,255)	\$ 1,022

Note 5. Exploration and Dry Hole Costs

These costs relate primarily to the exploration work being performed on MPAL's properties. During the six months ended December 31, 2007, the Company incurred dry hole costs of \$1,505,000 in the Cooper Basin and \$125,000 in the Weald Basin in the United Kingdom.

Note 6. Asset Retirement Obligations

A reconciliation of the Company's asset retirement obligations for the six months ended December 31, 2007 was as follows:

Balance at July 1, 2007	\$ 9,456,088
Liabilities incurred	
Liabilities settled	
Accretion expense	346,388
Revisions to estimate	42,882
Exchange effect	376,741
Balance at December 31, 2007	\$ 10,222,099

Note 7. Income Taxes

As previously disclosed, the Australian Taxation Office (ATO) conducted an audit of the Australian income tax returns of MPAL and its wholly owned subsidiaries for the years 1997- 2005. The ATO audit focused on certain income tax deductions claimed by Paroo Petroleum Pty. Ltd. (PPPL), a wholly-owned subsidiary of MPAL related to the write-off of outstanding loans made by PPPL to other entities within the MPAL group of companies. As a result of this audit, the ATO in August, 2007 issued position papers which set forth its opinions that these previous deductions should be disallowed, resulting in additional income taxes being payable by MPAL and its subsidiaries. In the position papers, the ATO sets out its legal basis for its conclusions. The ATO indicated in its position papers that the increase in taxes arising from its proposed positions would be (Aus.) \$13,392,460 plus possible interest and penalties, which could have exceeded the amount of the increased taxes asserted by the ATO.

In a comprehensive audit conducted by the ATO in the period 1992-94, the ATO concluded that PPPL was carrying on business as a money lender and accordingly, should, for taxation purposes, account for its interest income on an accrual basis rather than a cash basis. MPAL accepted this conclusion and from that point has been determining its annual Australian taxation liability on this basis (including claiming deductions for bad debts as a money lender).

Recently, the ATO has taken a more aggressive approach with respect to its views regarding income tax deductions attributable to in-house finance companies. Since this change in approach, the ATO has commenced audits of a number of companies involving, among other issues, the appropriate treatment of bad debt deductions taken by in-house finance companies. Magellan understands that, at this time, while there have been negotiated settlements in relation to some of these audits, none of them has reached final resolution in court.

Based upon the advice of Australian tax counsel, the Company and the ATO held settlement discussions concerning this matter during this quarter. In order to avoid a protracted and costly legal battle with the ATO, diversion of company management and resources away from Company business and the possibility of significantly higher payments with a loss in court, the Company decided to settle this matter. On December 19, 2007, MPAL reached a non-binding agreement in principle to settle this dispute for an aggregate settlement payment by MPAL to the ATO of (Aus) \$14,641,994. The aggregate settlement payment is comprised of (Aus) \$10,340,796 in amended taxes and (AUS) \$4,301,198 of interest on the amended taxes. No penalties were to be assessed as part of the terms of the settlement. The agreement in principle to settle the dispute was conditioned upon MPAL and the ATO agreeing on formal terms of settlement in a binding agreement (the Deed of Settlement) which the parties agreed to negotiate and sign promptly. As further agreed by the parties, the ATO issued assessments for the agreed upon amended tax liabilities in January 2008. Under the final terms of the Deed of Settlement signed by the parties on February 7, 2008, MPAL agreed not to object to or appeal the ATO's amended assessments. The Deed of Settlement with the ATO constitutes a complete release and extinguishment of the tax liabilities of MPAL and its subsidiaries with respect to the amended assessments and the prior bad debt deductions.

On January 21, 2008 MPAL paid (AUS) \$5,000,000 to the ATO as a deposit towards this settlement. The remaining (AUS) \$9,641,994 is scheduled to be paid by MPAL on February 14, 2008.

Both the amended taxes and interest in the amount of US\$12,836,636 has been recorded as part of the income tax provision for the quarter ended December 31, 2007 (\$.31 per share).

The Company adopted FIN 48 on July 1, 2007. Under FIN 48, a company recognizes an uncertain tax position (UTP) based on whether it is more likely than not that the UTP will be sustained upon examination by the appropriate taxing authority, including resolution of any related appeals or litigation processes, based solely on the technical merits of the position. In evaluating whether a UTP has met the more-likely-than-not recognition threshold, a company must presume that its positions will be examined by the appropriate taxing authority that has full knowledge of all relevant information. The second step of FIN 48 adoption is measurement. A UTP that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. The UTP is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. A UTP is not recognized if it does not meet the more-likely-than-not threshold.

Upon the adoption of FIN 48, MPAL received a legal opinion from its Australian tax counsel that concluded that the Company would be more likely than not to sustain these deductions in court. Australian tax counsel also advised

the Company that 100% of the tax benefit of these deductions is the largest amount of the benefit that would be more than 50% likely to be realized. As a result, the Company recorded no liability for this UTP prior to the settlement which was negotiated in December.

The components of the income tax (in thousands) between MPC and MPAL are as follows:

8

	3 MONTHS ENDED DECEMBER 31		6 MONTHS ENDED DECEMBER 31	
	2007	2006	2007	2006
Income before income taxes	\$ 1,547	\$ 248	\$ 1,079	\$ 1,969
Tax at 30%	464	74	324	591
MPC's non Australian loss	195	129	337	257
Non-taxable Australian revenue	(162)	(114)	(225)	(199)
Depletion on step up basis oil & gas properties		165	19	293
Other permanent differences	10	2	11	5
ATO assessment of prior year taxes, net of interest expense benefit	11,706		11,706	
Increase in valuation reserve for foreign (UK) exploration expenditures	107		140	
Australian income tax provision	12,320	256	12,312	947
MPC income tax provision(a)	7		22	
Consolidated income tax provision	\$ 12,327	\$ 256	\$ 12,334	\$ 947
Current income tax provision	\$ 12,644	\$ 19	\$ 12,659	\$ 889
Deferred income tax (benefit) provision	(317)	237	(325)	58
Income tax provision	\$ 12,327	\$ 256	\$ 12,334	\$ 947
Effective tax rate	416%	103%	114%	48%

(a) MPC's income tax provisions represent the 25% Canadian withholding tax on its Kotaneelee gas field carried interest net proceeds.

The Company has made a policy election that interest and penalty costs, if incurred, will be classified as income taxes in the Company's financial statements. The tax years that remain open and subject to examination by tax jurisdictions are fiscal 2004 to present in the United States and fiscal 1996 to present in Australia except for the issues agreed upon in the Deed of Settlement discussed above which are now closed.

Note 8. Restatement of Financial Information

Subsequent to the issuance of the consolidated financial statements for the period ended December 31, 2007, the Company's management determined that depletion expense was miscalculated due to the misapplication of reserve information for a group of new wells which principally began production in fiscal 2008. Depletion expense for the three and six-month period ended December 31, 2007 was understated by \$1,569,466 and \$2,816,574, respectively.

As a result, the consolidated financial statements for the period ended December 31, 2007 have been restated. The restatement has no impact on the consolidated cash flows from operations or cash and cash equivalent balances for the period presented in this Form 10-Q/A.

The following is a summary of the effect of the restatement on the originally issued Consolidated Statements of Operations for the three and six months ended December 31, 2007, Consolidated Balance Sheet as of December 31, 2007 and Consolidated Statement of Cash Flows for the six months ended December 31, 2007:

31,800,103 32,462,220

Cash dividends declared per common share

\$- \$0.01

See accompanying notes

LRAD Corporation

Consolidated Statements of Comprehensive Loss

	Three months ended	
	December 31,	2015
	2016	
Net loss	\$ (812,680)	\$ (380,073)
Other comprehensive loss, net of tax:		
Unrealized loss on marketable securities, net of tax	(6,310)	(4,208)
Other comprehensive loss	(6,310)	(4,208)
Comprehensive loss	\$ (818,990)	\$ (384,281)

See accompanying notes

LRAD Corporation**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Unaudited)

	Three months ended	
	December 31,	
	2016	2015
Operating Activities:		
Net loss	\$(812,680)	\$(380,073)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	32,506	56,884
Warranty provision	9,696	(22,267)
Inventory obsolescence	24	6,081
Share-based compensation	464,749	147,940
Deferred income taxes	(486,528)	(311,195)
Changes in operating assets and liabilities:		
Accounts receivable	1,929,765	174,339
Inventories	(327,680)	(294,426)
Prepaid expenses and other	80,378	118,028
Other assets	46,871	46,871
Accounts payable	500,042	(226,055)
Payroll and related	180,766	1,459
Warranty settlements	(12,742)	(972)
Accrued and other liabilities	(176,881)	289,243
Net cash provided by (used in) operating activities	1,428,286	(394,143)
Investing Activities:		
Sales (purchases) of marketable securities	84,610	(623,604)
Capital expenditures	(13,863)	(71,150)
Patent costs paid	(1,721)	(1,205)
Net cash provided by (used in) investing activities	69,026	(695,959)
Financing Activities:		
Repurchase of common stock	-	(1,643,120)
Net cash used in financing activities	-	(1,643,120)
Net increase (decrease) in cash	1,497,312	(2,733,222)
Cash and cash equivalents, beginning of period	13,466,711	18,316,103
Cash and cash equivalents, end of period	\$ 14,964,023	\$ 15,582,881

See accompanying notes

LRAD Corporation

Notes to Condensed Consolidated Financial Statements (Unaudited)

1. OPERATIONS

LRAD[®] Corporation, a Delaware corporation (the “Company”), is engaged in the design, development and commercialization of directed and omnidirectional sound technologies and products. The Company sells its proprietary sound reproduction technologies and products in markets around the world.

2. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

General

The Company’s unaudited interim condensed consolidated financial statements included herein have been prepared in accordance with the instructions to Form 10-Q and Article 8 of Regulation S-X and the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. In management’s opinion, the accompanying statements reflect adjustments necessary to present fairly the financial position, results of operations, and cash flows for those periods indicated, and contain adequate disclosure to make the information presented not misleading. Adjustments included herein are of a normal, recurring nature unless otherwise disclosed in the footnotes. The condensed consolidated financial statements and notes thereto should be read in conjunction with the Company’s audited financial statements and notes thereto for the year ended September 30, 2016 included in the Company’s Annual Report on Form 10-K, as filed with the SEC on December 7, 2016. Results of operations for interim periods are not necessarily indicative of the results of operations for a full year.

Principles of Consolidation

The Company has a currently inactive wholly owned subsidiary, LRAD International Corporation, which the Company formed to conduct international marketing, sales and distribution activities. The condensed consolidated financial statements include the accounts of this subsidiary after elimination of intercompany transactions and

accounts.

Reclassifications

Where necessary, the prior year's information has been reclassified to conform to the current year presentation.

3. RECENT ACCOUNTING PRONOUNCEMENTS

In March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-09, *Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*. This guidance changes how companies account for certain aspects of share-based payments to employees.

Among other things, under the new guidance, companies will no longer record excess tax benefits and certain tax deficiencies in additional paid-in-capital ("APIC"), but will instead record such items as income tax expense or benefit in the income statement, and APIC pools will be eliminated. Companies will apply this guidance prospectively. Another component of the new guidance allows companies to make an accounting policy election for the impact of forfeitures on the recognition of expense for share-based payment awards, whereby forfeitures can be estimated, as required today, or recognized when they occur. If elected, the change to recognize forfeitures when they occur needs to be adopted using a modified retrospective approach. All of the guidance will be effective for the Company in the fiscal year beginning October 1, 2017. Early adoption is permitted. The Company is currently evaluating the impact of this guidance, if any, on its financial statements and related disclosures.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*, which issued new guidance related to leases that outlines a comprehensive lease accounting model and supersedes the current lease guidance. The new guidance requires lessees to recognize lease liabilities and corresponding right-of-use assets for all leases with lease terms of greater than 12 months. It also changes the definition of a lease and expands the disclosure requirements of lease arrangements. The new guidance must be adopted using the modified retrospective approach and will be effective for the Company in the fiscal year beginning October 1, 2019. Early adoption is permitted. The Company is currently evaluating the impact of this guidance, if any, on its financial statements and related disclosures.

In July 2015, the FASB issued ASU No. 2015-11, *Inventory (Topic 330): Simplifying the Measurement of Inventory*.

The guidance requires an entity to measure inventory at the lower of cost or net realizable value, which is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation, rather than the lower of cost or market in the previous guidance. This amendment applies to inventory that is measured using first-in, first-out (FIFO). This amendment is effective for the Company in the fiscal year beginning October 1, 2017. A reporting entity should apply the amendments prospectively with earlier application permitted as of the beginning of an interim or annual reporting period. The Company is currently evaluating the impact of this guidance, if any, on its consolidated financial statements and related disclosures.

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers* (“ASU 2014-09”), which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. ASU 2014-09 will replace most existing revenue recognition guidance in U.S. generally accepted accounting principles when it becomes effective. In July 2015, the FASB deferred the effective date of the standard by an additional year; however, it provided companies the option to adopt one year earlier, commensurate with the original effective date. Accordingly, the standard will be effective for the Company in the fiscal year beginning October 1, 2018, with an option to adopt the standard for the fiscal year beginning October 1, 2017. The Company is currently evaluating this standard and has not yet selected a transition method or the effective date on which it plans to adopt the standard, nor has it determined the effect of the standard on its financial statements and related disclosures.

4. FAIR VALUE MEASUREMENTS

The Company’s financial instruments consist principally of cash equivalents, short and long-term marketable securities, accounts receivable and accounts payable. The fair value of a financial instrument is the amount that would be received in an asset sale or paid to transfer a liability in an orderly transaction between unaffiliated market participants. Assets and liabilities measured at fair value are categorized based on whether or not the inputs are observable in the market and the degree that the inputs are observable. The categorization of financial instruments within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

The hierarchy is prioritized into three levels (with Level 3 being the lowest) defined as follows:

Level 1: Inputs are based on quoted market prices for identical assets or liabilities in active markets at the measurement date.

Level 2: Inputs include quoted prices for similar assets or liabilities in active markets and/or quoted prices for identical or similar assets or liabilities in markets that are not active near the measurement date.

Level 3: Inputs include management’s best estimate of what market participants would use in pricing the asset or liability at the measurement date. The inputs are unobservable in the market and significant to the instrument’s valuation.

The fair value of the Company’s cash equivalents and marketable securities was determined based on Level 1 and Level 2 inputs. The Company did not have any marketable securities in the Level 3 category as of December 31, 2016 or September 30, 2016. The Company believes that the recorded values of its other financial instruments approximate their current fair values because of their nature and respective relatively short maturity dates or durations.

Instruments Measured at Fair Value

The following tables present the Company's cash equivalents and marketable securities' costs, gross unrealized gains and losses, and fair value by major security type recorded as cash equivalents or short-term or long-term marketable securities as of December 31, 2016 and September 30, 2016.

	December 31, 2016					
	Cost Basis	Unrealized Gains/(Losses)	Fair Value	Cash Equivalents	Short-term Securities	Long-term Securities
Level 1:						
Money Market Funds	\$-	\$ -	\$45,984	\$ 45,984	\$-	\$-
Level 2:						
Certificates of deposit	\$2,237,189	\$ -	\$2,237,189	\$ -	\$1,800,000	\$437,189
Municipal securities	40,313	-	40,313	-	40,313	-
Corporate bonds	2,763,097	(7,859)	2,755,238	-	1,270,295	1,484,943
Subtotal	5,040,599	(7,859)	5,032,740	-	3,110,608	1,922,132
Total	\$5,040,599	\$ (7,859)	\$5,078,724	\$ 45,984	\$3,110,608	\$1,922,132

	September 30, 2016					
	Cost Basis	Unrealized Gains/(Losses)	Fair Value	Cash Equivalents	Short-term Securities	Long-term Securities
Level 1:						
Money Market Funds	\$-	\$ -	\$95,538	\$ 95,538	\$-	\$-
Level 2:						
Certificates of deposit	\$3,236,168	\$ -	\$3,236,168	\$ -	\$1,299,133	\$1,937,035
Municipal securities	140,637	-	140,637	-	140,637	-
Corporate bonds	1,748,404	(1,549)	1,746,855	-	1,496,354	250,501
Subtotal	5,125,209	(1,549)	5,123,660	-	2,936,124	2,187,536
Total	\$5,125,209	\$ (1,549)	\$5,219,198	\$ 95,538	\$2,936,124	\$2,187,536

5. INVENTORIES

Inventories consisted of the following:

	December 31, 2016	September 30, 2016
Raw materials	\$4,129,237	\$4,393,928
Finished goods	1,051,735	775,628
Work in process	490,749	174,485
Inventories, gross	5,671,721	5,344,041
Reserve for obsolescence	(580,156)	(580,132)
Inventories, net	\$5,091,565	\$4,763,909

6. PROPERTY AND EQUIPMENT

Property and equipment consisted of the following:

December 31, 2016	September 30, 2016
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Machinery and equipment	\$955,226	\$957,829
Office furniture and equipment	988,922	976,856
Leasehold improvements	76,138	71,738
Property and equipment, gross	2,020,286	2,006,423
Accumulated depreciation	(1,563,763)	(1,533,079)
Property and equipment, net	\$456,523	\$473,344

**Three months
ended
December 31,
2016 2015**

Depreciation expense	\$30,684	\$55,245
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7. ACCRUED LIABILITIES AND OTHER LIABILITIES—NONCURRENT

Accrued liabilities consisted of the following:

	December 31, 2016	September 30, 2016
Payroll and related	\$563,611	\$382,845
Deferred revenue	373,028	637,763
Warranty reserve	297,576	285,402
Accrued contract costs	295,551	197,034
Total	\$1,529,766	\$1,503,044

Other liabilities - noncurrent consisted of the following:

Deferred rent	\$82,793	\$93,456
Extended warranty	56,362	71,582
Total	\$139,155	\$165,038

Payroll and related

Payroll and related consists primarily of accrued vacation, bonus, sales commissions, and benefits.

Deferred Revenue

Deferred revenue consists primarily of prepayments from customers in advance of product shipment.

Warranty Reserve

Changes in the warranty reserve and extended warranty were as follows:

	Three months ended December 31,	
	2016	2015
Beginning balance	\$356,984	\$315,618
Warranty provision	9,696	(22,267)
Warranty settlements	(12,742)	(972)
Ending balance	\$353,938	\$292,379

	December 31, 2016	September 30, 2016
Short-term warranty reserve	\$297,576	\$285,402
Long-term warranty reserve	56,362	71,582
Total warranty reserve	\$353,938	\$356,984

Accrued contract costs

We have contracted with a third party service provider to administer the required services under the terms of a repair and maintenance agreement with a foreign military. This payment is made in arrears for each contract year ended March 26.

8. INCOME TAXES

At December 31, 2016, the Company had federal net operating losses (“NOLs”) and related state NOLs. The Company released \$188,000 and \$8,339,000 of its valuation allowance against its deferred tax assets during the years ended September 30, 2016 and 2015, respectively, as it determined that it was more likely than not that those assets would be realized. The Company continues to maintain a valuation allowance of \$12,109,000 at September 30, 2016 and December 31, 2016 as the Company believes that the negative evidence that it will be able to recover these net deferred tax assets outweighs the positive evidence.

The Company recorded an income tax benefit of \$486,528 and \$309,595, reflecting effective tax rates of 37.4% and 44.9% for the three months ended December 31, 2016 and 2015, respectively. The tax benefit recorded in these two periods is related to the company’s losses for those periods and the determination that a valuation allowance is not required on the benefit related to those losses.

Accounting Standard Codification (“ASC”) 740, *Accounting for Uncertainty in Income Taxes*, requires the Company to recognize in its consolidated financial statements uncertainties in tax positions taken that may not be sustained upon examination by the taxing authorities. If interest or penalties are assessed, the Company would recognize these charges as income tax expense. The Company has not recorded any income tax expense or benefit for uncertain tax positions.

9. COMMITMENTS AND CONTINGENCIES

Litigation

The Company may at times be involved in litigation in the ordinary course of business. The Company will, from time to time, when appropriate in management’s estimation, record adequate reserves in the Company’s consolidated financial statements for pending litigation. Currently, there are no pending material legal proceedings to which the Company is a party or to which any of its property is subject.

Bonus Plan

The Company has an incentive bonus plan for fiscal year 2017 designed to motivate its employees to achieve the Company’s financial objectives. All of the Company’s employees are entitled to participate in the incentive plan. Target Bonus Amounts (“Target”) vary based on a percentage of the employee’s base salary which range from 10% to 75% of base salary and a bonus payment may be made at three levels, including at 50% of Target, at 100% of Target and at 200% of Target, depending upon the achievement by the Company of specified performance goals. Performance targets include certain fiscal 2017 metrics, including product bookings, net revenues, operating income and operating cash flow, depending on the employee’s position. Included in such calculation is the cost of the incentive plan. During the three months ended December 31, 2016 and 2015, the Company accrued \$185,086 and \$0, respectively, for bonuses and related payroll tax expenses in connection with the bonus plans.

10. SHARE-BASED COMPENSATION

Stock Option Plans

At December 31, 2016, the Company had two equity incentive plans. The 2005 Equity Incentive Plan (“2005 Equity Plan”) was terminated with respect to new grants in March 2015, but remains in effect for grants issued prior to that time. The 2015 Equity Incentive Plan (“2015 Equity Plan”) was approved by the Company’s Board of Directors on January 19, 2015 and by the Company’s stockholders on March 18, 2015. The 2015 Equity Plan authorizes for issuance as stock options, restricted stock, stock appreciation rights, restricted stock units and performance awards, an aggregate of 5,000,000 new shares of common stock to employees, directors, advisors or consultants. At December 31, 2016, there were options outstanding covering 2,477,502 and 2,371,500 shares of common stock under the 2005 Equity Plan and 2015 Equity Plan, respectively.

Stock Option Activity

The following table summarizes information about stock option activity during the three months ended December 31, 2016:

	Number of Shares	Weighted Average Exercise Price
Outstanding October 1, 2016	4,404,002	\$ 2.18
Granted	448,500	\$ 1.70
Forfeited/expired	(3,500)	\$ 2.20
Outstanding December 31, 2016	4,849,002	\$ 2.14
Exercisable December 31, 2016	3,148,103	\$ 2.26

Options outstanding are exercisable at prices ranging from \$0.93 to \$3.17 and expire over the period from 2018 to 2023 with an average life of 4.6 years. The aggregate intrinsic value of options outstanding and exercisable at December 31, 2016 was \$149,619 and \$127,298, respectively.

During the quarter ended December 31, 2016, the Company incurred non-cash share-based compensation expense of \$307,324 resulting from the modification of stock options in accordance with a Separation Agreement and General Release related to the June 30, 2016 departure of the Company’s prior chief executive officer (“CEO”). As per the agreement, all unvested options became fully vested on December 31, 2016 and shall remain exercisable for a period of 24 months following the December 31, 2016 separation date as defined in the agreement. The expense is measured as the excess of the fair value of the modified awards over the fair value of the original awards immediately before its terms are modified as per ASC 718-20-35.

During the quarter ended December 31, 2016, the Board of Directors approved the grant of 25,000 restricted stock units to each of our non-employee directors, subject to stockholder approval of the Amended and Restated 2015 Equity Incentive Plan at the 2017 Annual Meeting of Stockholders. These restricted stock units were granted as replacements for 20,000 stock options that would have been granted on the date of the 2016 Annual Meeting of Stockholders and will vest on the first anniversary of the 2016 Annual Meeting of Stockholders, which is May 17, 2017.

Share-Based Compensation

The Company recorded share-based compensation expense and classified it in the condensed consolidated statements of operations as follows:

	Three months ended December 31,	
	2016	2015
Cost of revenues	\$5,877	\$5,637
Selling, general and administrative	435,497	117,955
Research and development	23,375	24,348
Total	\$464,749	\$147,940

The employee stock options granted in the three months ended December 31, 2016 and 2015 had a weighted-average estimated fair value of \$0.71 per share and \$0.63 per share, respectively, using the Black-Scholes option pricing model with the following weighted-average assumptions (annualized percentages):

	Three months ended December 31,			
	2016		2015	
Volatility	52.4% -	53.7%	51.0% -	52.0%
Risk-free interest rate	1.7% -	2.0%	1.5% -	1.7%
Forfeiture rate	10.0%		10.0%	
Dividend yield	0.0%		2.2% -	2.7%
Expected life in years	3.8 -	4.6	3.8 -	4.6

The Company declared a dividend for the quarter ended December 31, 2015, which reflects a dividend yield assumption based on the expected annual yield, but the dividend was discontinued prior to the quarter ended December 31, 2016. Expected volatility is based on the historical volatility of the Company's common stock over the period commensurate with the expected life of the options. The risk-free interest rate is based on rates published by

the Federal Reserve Board. The expected life is based on observed and expected time to post-vesting exercise. The expected forfeiture rate is based on past experience and employee retention data. Forfeitures are estimated at the time of the grant and revised in subsequent periods if actual forfeitures differ from those estimates or if the Company updates its estimated forfeiture rate. Such amounts will be recorded as a cumulative adjustment in the period in which the estimate is changed.

Since the Company has an NOL carryforward as of December 31, 2016, no excess tax benefit for the tax deductions related to share-based awards was recognized for the three months ended December 31, 2016 and 2015. As of December 31, 2016, there was approximately \$900,000 of total unrecognized compensation cost related to non-vested share-based employee compensation arrangements. The cost is expected to be recognized over a weighted-average period of 2.2 years.

11. STOCKHOLDERS' EQUITY

Summary

The following table summarizes changes in the components of stockholders' equity during the three months ended December 31, 2016:

	Common Stock Shares	Amount	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total Stockholders' Equity
Balances, September 30, 2016	31,800,103	\$ 318	\$86,467,215	\$(51,895,099)	\$ (1,549)) \$34,570,885
Share-based compensation expense	-	-	464,749	-	-) 464,749
Other comprehensive loss	-	-	-	-	(6,310)) (6,310)
Net loss	-	-	-	(812,680)	-) (812,680)
Balances, December 31, 2016	31,800,103	\$ 318	\$86,931,964	\$(52,707,779)	\$ (7,859)) \$34,216,644

Share Buyback Program

The Board of Directors approved a share buyback program in 2015 under which the Company was authorized to repurchase up to \$4 million of its outstanding common shares. This program expired on December 31, 2016 and in December 2016, the Board extended the program through December 31, 2017. There were no shares repurchased during the three months ended December 31, 2016. During the three months ended December 31, 2015, 1,031,208 shares were repurchased for \$1,643,120 under the prior repurchase program.

Dividends

On December 3, 2015, the Company announced a cash dividend of \$0.01 per share on the Company's common stock, payable on January 29, 2016 to stockholders of record on January 15, 2016. There were no dividends declared in the three months ended December 31, 2016.

12. LOSS PER SHARE

The following table sets forth the computation of basic and diluted loss per share:

	Three months ended December 31,	
	2016	2015
Numerator:		
Loss available to common stockholders	\$(812,680)	\$(380,073)
Denominator:		
Weighted average common shares outstanding	31,800,103	32,462,220
Basic and diluted loss per common share	\$(0.03)	\$(0.01)
Potentially dilutive securities outstanding at period end excluded from the diluted computation as the inclusion would have been antidilutive:		
Options	4,849,002	2,999,002
Warrants	-	1,627,945
Total	4,849,002	4,626,947

13. MAJOR CUSTOMERS

For the three months ended December 31, 2016, revenues from one customer accounted for 11% of total revenues, with no other single customer accounting for more than 10% of revenues. At December 31, 2016, accounts receivable from two customers accounted for 40% and 19% of total accounts receivable, respectively, with no other single customer accounting for more than 10% of the accounts receivable balance.

For the three months ended December 31, 2015, revenues from two customers accounted for 16% and 11% of total revenues, respectively, with no other single customer accounting for more than 10% of revenues. At December 31, 2015, accounts receivable from three customers accounted for 30%, 13% and 12% of total accounts receivable, respectively, with no other single customer accounting for more than 10% of the accounts receivable balance.

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

The discussion and analysis set forth below should be read in conjunction with the accompanying unaudited condensed consolidated financial statements and the related notes included under Item 1 of this Quarterly Report on Form 10-Q, together with Management's Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended September 30, 2016.

Forward Looking Statements

This report contains certain statements of a forward-looking nature relating to future events or future performance. Words such as "expects," "anticipates," "intends," "plans," "believes," "seeks," "estimates" and similar expressions or variations of such words are intended to identify forward-looking statements, but are not the only means of identifying forward-looking statements. Prospective investors are cautioned that such statements are only predictions and actual events or results may differ materially. In evaluating such statements, prospective investors should specifically consider various factors identified in this report and any matters set forth under Part I, Item 1A (Risk Factors) of our Annual Report on Form 10-K, which could cause actual results to differ materially from those indicated by such forward-looking statements.

Overview

Our Company develops and delivers highly intelligible, directed Long Range Acoustic Devices® ("LRAD®") that beam, focus and control sound over short and long distances. By placing sound only where needed, we not only enhance many typical speaker applications, but we offer novel sound applications that conventional speakers cannot achieve.

Our LRAD-X® product line offers a variety of directed sound products, which use focused acoustic output to clearly transmit critical information, instructions and warnings over long distances. The LRAD-X product line features clear voice intelligibility and meets the military's stringent environmental requirements in a number of packages and form factors, from our hand held LRAD 100X to our LRAD 2000X unit, which communicates up to 5,500 meters. Through the use of powerful voice commands, prerecorded messages in multiple languages, and warning tones, our LRAD-X products are designed to create large safety zones while determining the intent and influencing the behavior of security threats. We continue to expand our LRAD-X product line to provide a complete range of systems and accessories, including a new, patent pending XL speaker technology introduced in 2014, which generates higher audio output in a smaller and lighter form factor, and has been incorporated in several new products in recent years. Our products are designed to meet a broad range of diverse applications including fixed and mobile military deployments, maritime security, critical infrastructure and perimeter security, commercial security, border and homeland security, law enforcement and emergency responder communications, asset protection and wildlife preservation and control. Our LRAD-X products have been competitively selected over other commercially available systems by the United

States military and by several international militaries.

Building on the success of our LRAD-X directional technology, in 2012 we launched our first omnidirectional product, the LRAD 360X. Unlike standard siren systems in the market, the LRAD 360X is designed with the same highly intelligible voice clarity, and the ability to communicate and alert over long distances, as in our directional products. Since the LRAD 360X product launch, we have expanded our ONE VOICE® omnidirectional product line to include various size offerings, a 60-degree unit, a mobile trailer-mounted system, and various configurations of amplifiers, power sources, software and other products to provide a more fully integrated mass notification solution for municipalities, military bases, airports, college/business campuses, etc. We expect that the ONE VOICE product line will allow us to expand our business opportunities into the large and growing worldwide emergency warning and mass notification market. Through increased focus and investment in domestic and international sales and marketing activities, we have pioneered a new global market, selling our directional LRAD-X long-range acoustic hailing devices (“AHDs”) and advanced ONE VOICE omnidirectional mass notification systems into over 70 countries.

Revenues in the first fiscal quarter ended December 31, 2016, were \$2.9 million, an increase from \$2.8 million in the first fiscal quarter of 2016. The increase in revenues was driven by \$708,000 of mass notification revenues compared to \$277,000 in the first fiscal quarter of 2016. In addition to the improved shipments, we received several large mass notification orders in the first fiscal quarter of 2017, including a \$1.3 million mobile mass notification systems order for a large oil and gas company in Eurasia for public address, emergency communication and early warning; a large order for a major maritime port installation and integration using LRAD command and control software; a 360X system and accessory order for a National Guard state headquarters and several follow-on orders for tsunami warning installations in Japan. U.S. revenues remained strong in the fiscal 2017 first quarter with an LRAD 1000RX systems order for perimeter safety and security for utility infrastructure, and a U.S. Navy spares order. Our bookings during the fiscal 2017 first quarter were strong, which we believe will be a good indicator for the second quarter of fiscal 2017.

Based on the timing of budget cycles, as well as financial issues and military conflict in certain areas of the world, delays in awarding contracts often occur, resulting in uneven quarterly revenues. As a result of the U.S. presidential election and new administration, U.S. defense spending may increase, though it is too early to tell what the priorities will be. Demand for our products remains strong and we continue to build awareness and interest in our LRAD-X and

ONE VOICE mass notification products throughout the world. On a quarter over quarter basis, our revenues are expected to remain uneven. Gross profit decreased compared to the same quarter in the prior year as a result of lower product margins due to product mix. Operating expenses increased by 26.3% from \$2.0 million to \$2.6 million in the quarter ended December 31, 2016, primarily due to an increase in non-cash share-based compensation expense from the modification of stock options in accordance with a Separation Agreement and General Release related to the June 30, 2016 departure of the Company’s prior CEO and a bonus accrual based on the Company’s expectation for meeting current year financial goals. We reported a net loss of \$812,680 for the quarter, or \$0.03 per share, compared to a net loss of \$380,073, or \$0.01 per share for the same quarter in the prior year.

Overall Business Outlook

Our product line-up continues to gain worldwide awareness and recognition through media exposure, trade show participations, product demonstrations and word of mouth as a result of positive responses and increased acceptance of our products. We believe we have a solid global brand, technology and product foundation with our LRAD-X directed product line, which we have expanded over the years to service new markets and customers for greater business growth. We have launched a line of omnidirectional products targeted to meet the needs of the large and growing mass notification market. We believe that we have strong market opportunities for our directional and omnidirectional product offerings within the global government and military sector, as well as increasing commercial applications as a result of continued threats to governments, commerce and law enforcement, and in wildlife preservation and control applications. We intend to continue expanding our international mass notification business, particularly in the Middle East, Europe and Asia where we believe there are greater market opportunities for our omnidirectional products. Our selling network has expanded through the addition of sales consultants as well as continuing to improve and increase our relationships with key integrators and sales representatives within the United States and in a number of worldwide locations. However, we may continue to face challenges in fiscal 2017 due to continuing economic and geopolitical conditions in some international regions. We anticipate that the new U.S. government administration will support U.S. Military spending, which we believe could benefit us, although there is uncertainty as to priorities and timing. We continue to pursue large business opportunities, but it is difficult to anticipate how long it will take to close these opportunities, or if they will ever ultimately come to fruition. It is also difficult to determine whether our omnidirectional product will be accepted as a viable solution in the mass notification market, which includes a number of large, well-known competitors.

Critical Accounting Policies

We have identified a number of accounting policies as critical to our business operations and the understanding of our results of operations. These are described in our consolidated financial statements located in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended September 30, 2016. The impact and any associated risks related to these policies on our business operations is discussed below and throughout Management's Discussion and Analysis of Financial Condition and Results of Operations when such policies affect our reported and expected financial results.

The methods, estimates and judgments we use in applying our accounting policies, in conformity with generally accepted accounting principles in the U.S., have a significant impact on the results we report in our financial statements. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. The estimates affect the carrying values of assets and liabilities. Actual results may differ from these estimates under different assumptions or conditions.

Comparison of Results of Operations for the Three Months Ended December 31, 2016 and 2015**Revenues**

The following table sets forth for the periods indicated certain items of our condensed consolidated statements of operations expressed in dollars and as a percentage of net revenues. The financial information and the discussion below should be read in conjunction with the condensed consolidated financial statements and notes contained in this report.

	Three months ended December 31, 2016		December 31, 2015		Fav(Unfav)	
	Amount	% of Total Revenues	Amount	% of Total Revenues	Amount	%
Revenues:						
Product sales	\$2,701,959	91.9 %	\$2,563,807	90.9 %	\$138,152	5.4 %
Contract and other	239,375	8.1 %	257,725	9.1 %	(18,350)	(7.1 %)
Total revenues	2,941,334	100.0 %	2,821,532	100.0 %	119,802	4.2 %
Cost of revenues	1,716,824	58.4 %	1,523,170	54.0 %	(193,654)	(12.7 %)
Gross profit	1,224,510	41.6 %	1,298,362	46.0 %	(73,852)	(5.7 %)
Operating expenses:						
Selling, general and administrative	1,966,436	66.9 %	1,460,092	51.7 %	(506,344)	(34.7 %)
Research and development	587,410	19.9 %	561,202	19.9 %	(26,208)	(4.7 %)
Total operating expenses	2,553,846	86.8 %	2,021,294	71.6 %	(532,552)	(26.3 %)
Loss from operations	(1,329,336)	(45.2 %)	(722,932)	(25.6 %)	(606,404)	(83.9 %)
Other income	30,128	1.0 %	33,264	1.1 %	(3,136)	(9.4 %)
Loss from operations before income taxes	(1,299,208)	(44.2 %)	(689,668)	(24.5 %)	(609,540)	(88.4 %)
Income tax benefit	(486,528)	(16.6 %)	(309,595)	(11.0 %)	176,933	57.1 %
Net loss	\$(812,680)	(27.6 %)	\$(380,073)	(13.5 %)	\$(432,607)	(113.8 %)

Revenues increased in the current quarter compared to the prior year due to strong mass notification revenues in the U.S. and internationally. Mass notification shipments included both outside and indoor tsunami warning application, power plant security, U.S. Navy communication on carriers and amphibious ships, and an oil and gas application. U.S. revenues were also strong with an LRAD 1000RX systems order for perimeter safety and security for utility infrastructure, and a U.S. Navy spares order. The receipt of orders will often be uneven due to the timing of approvals

or budgets. At December 31, 2016, we had aggregate deferred revenue of \$373,028 for prepayments from customers in advance of product shipment.

Gross Profit

The decrease in gross profit in the quarter was primarily due to unfavorable product margins due to product mix, partially offset by increased volume and lower expenses related to an annual maintenance contract.

Our products have varying gross margins, so product mix may affect gross profits. In addition, our margins vary based on the sales channels through which our products are sold in a given period. We continue to implement product updates and changes, including raw material and component changes that may impact product costs. With such product updates and changes we have limited warranty cost experience and estimated future warranty costs can impact our gross margins. We do not believe that historical gross profit margins should be relied upon as an indicator of future gross profit margins.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased by \$317,542 for non-cash share-based compensation expenses, primarily due to non-recurring expense related to a Separation Agreement and General Release related to the departure of the Company's prior chief executive officer, \$126,594 for bonus accrual, \$41,672 for sales and marketing expense related to demo equipment and market research and \$20,536 of other expense.

We incurred non-cash share-based compensation expenses allocated to selling, general and administrative expenses in the three months ended December 31, 2016 and 2015 of \$435,497 and \$117,955, respectively.

We may expend additional resources on the marketing and selling of our products in future periods as we identify ways to optimize potential opportunities. Commission expenses will fluctuate based on the nature of our sales.

Research and Development Expenses

Research and development expenses increased compared to the prior year primarily due to \$42,995 for bonus accrual, offset by \$16,787 of reductions in spending.

Included in research and development expenses for the three months ended December 31, 2016 and 2015 was \$23,375 and \$24,348 of non-cash share-based compensation costs, respectively.

Research and development costs vary period to period due to the timing of projects, and the timing and extent of the use of outside consulting, design and development firms. We continually improve our product offerings and we expect to continue to expand our product line in 2017 with new products, customizations and enhancements. Based on current plans, we may expend additional resources on research and development in the current year compared to the prior year.

Net Loss

The increase in net loss was primarily due to the decrease in gross margin and increase in operating expenses, partially offset by an increase in income tax benefit. We recognized an income tax benefit of \$486,528 and \$309,595 for the three months ended December 31, 2016 and 2015, respectively.

Liquidity and Capital Resources

Cash and cash equivalents at December 31, 2016 was \$14,964,023, compared to \$13,466,711 at September 30, 2016 primarily as a result of cash generated from operations. Other than cash and expected future cash flows from operating activities in subsequent periods, we have no unused sources of liquidity at this time.

Principal factors that could affect our liquidity include:

• ability to meet sales projections;

• government spending levels;

• introduction of competing technologies;

• product mix and effect on margins;

• ability to reduce current inventory levels;

• product acceptance in new markets;

• value of shares repurchased; and

• value of dividends declared.

Principal factors that could affect our ability to obtain cash from external sources include:

• volatility in the capital markets; and

• market price and trading volume of our common stock.

Based on our current cash position, and assuming currently planned expenditures and level of operations, we believe we have sufficient capital to fund operations for the next twelve months. However, we operate in a rapidly evolving and unpredictable business environment that may change the timing or amount of expected future cash receipts and expenditures. Accordingly, there can be no assurance that we may not be required to raise additional funds through the sale of equity or debt securities or from credit facilities. Additional capital, if needed, may not be available on satisfactory terms, or at all.

Cash Flows

Our cash flows from operating, investing and financing activities, as reflected in the consolidated statements of cash flows, are summarized in the table below:

	Three Months Ended December 31,	
	2016	2015
Cash (used in) provided by:		
Operating activities	\$1,428,286	(394,143)
Investing activities	69,026	(695,959)
Financing activities	-	(1,643,120)

Operating Activities

Net loss of \$812,680 for the three months ended December 31, 2016 was decreased by \$20,447 of non-cash items that included deferred income taxes, share-based compensation, depreciation and amortization, warranty provision, and inventory obsolescence. Cash provided by operating activities in the current year reflected a decrease in accounts receivable of \$1,929,765 due to the collection of a high year-end balance, an increase in accounts payable of \$500,042 due to the timing of payments, payroll and related of \$180,766 primarily for accrued bonuses, and decreases in prepaid expenses and other of \$80,378 and other assets of \$46,871. Cash used in operating activities included an increase in inventory of \$327,680, a decrease in accrued and other liabilities of \$176,881 for decreased deferred revenue for customer prepayments and warranty settlements of \$12,742. Net loss of \$380,073 for the three months ended December 31, 2015 was increased by \$122,557 of non-cash items that included deferred income taxes, share-based compensation expense, depreciation and amortization, warranty provision and inventory obsolescence. Cash generated from operating activities reflected an increase in accrued and other liabilities of \$289,243, a decrease in accounts receivable of \$174,339, decreases in prepaid expenses and other of \$118,028, other assets of \$46,871 and payroll and related of \$1,459. Cash used in operating activities included an increase in inventory of \$294,426, a decrease in accounts payable of \$226,055 and warranty settlements of \$972.

We had accounts receivable of \$1,479,147 at December 31, 2016, compared to \$3,408,912 at September 30, 2016.

The level of trade accounts receivable at December 31, 2016 represented approximately 46 days of revenues compared to 64 days of revenues at September 30, 2016 due to the reduced accounts receivable balance. Terms with individual customers vary greatly. We typically require thirty-day terms from our customers if credit is approved. Our receivables can vary dramatically due to overall sales volume, quarterly variations in sales, timing of shipments to and receipts from large customers, payment terms, and the timing of contract payments.

At December 31 and September 30, 2016, our working capital was \$22,556,229 and \$23,093,684, respectively. The reduction in working capital was primarily due to a higher accounts payable balance due to the timing of payments.

Investing Activities

In the three months ended December 31, 2016, we decreased our holding of short and long-term marketable securities by \$84,610, compared to \$623,604 purchased in the three months ended December 31, 2015.

We also use cash in investing activities primarily for the purchase of tooling, computer equipment and software, and investment in new or existing patents. Cash used in investing activities for equipment and patents was \$15,584 and \$72,355 for the three months ended December 31, 2016 and 2015, respectively. We anticipate some additional expenditure for equipment and patents during the balance of fiscal year 2017.

Financing Activities

In the three months ended December 31, 2016, we did not use any cash for financing activities. In the three months ended December 31, 2015, we used \$1,643,120 for the repurchase of common stock.

The Board of Directors approved a share buyback program in 2015 under which the Company was authorized to repurchase up to \$4 million of its outstanding common shares. This program expired on December 31, 2016 and in December 2016, the Board extended the program through December 31, 2017. There were no shares repurchased during the three months ended December 31, 2016. During the three months ended December 31, 2015, 1,031,208 shares were repurchased for \$1,643,120 under the prior repurchase program.

Recent Accounting Pronouncements

New pronouncements issued for future implementation are discussed in Note 3, Recent Accounting Pronouncements, to our consolidated financial statements.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Foreign Currency Risk

We consider our direct exposure to foreign exchange rate fluctuations to be minimal. Currently, all sales to customers and all arrangements with third-party manufacturers, with one exception, provide for pricing and payment in U.S. dollars, and, therefore, are not subject to exchange rate fluctuations. Increases in the value of the U.S. dollar relative to other currencies could make our products more expensive, which could negatively impact our ability to compete. Conversely, decreases in the value of the U.S. dollar relative to other currencies could result in our suppliers raising their prices to continue doing business with us. Fluctuations in currency exchange rates could affect our business in the future.

Item 4. Controls and Procedures.

We are required to maintain disclosure controls and procedures designed to ensure that material information related to us, including our consolidated subsidiaries, is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms.

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our principal executive officer and our principal financial officer, we conducted an evaluation of our disclosure controls and procedures as such term is defined under Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934. Based on this evaluation, our principal executive officer and our principal financial officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level as of December 31, 2016.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting during our fiscal quarter ended December 31, 2016, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Our process for evaluating controls and procedures is continuous and encompasses constant improvement of the design and effectiveness of established controls and procedures and the remediation of any deficiencies, which may be identified during this process.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

We may at times be involved in litigation in the ordinary course of business. We will also, from time to time, when appropriate in management's estimation, record adequate reserves in our consolidated financial statements for pending litigation. Currently, there are no pending material legal proceedings to which the Company is a party or to which any of its property is subject.

Item 1A. Risk Factors.

As a Smaller Reporting Company as defined by Rule 12b-2 of the Exchange Act and in item 10(f)(1) of Regulation S-K, we are electing scaled disclosure reporting obligations and therefore are not required to provide the information requested by this item.

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

None

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

Not Applicable.

Item 5. Other Information.

None.

Item 6. Exhibits.

31.1 Certification of Richard S. Danforth, Principal Executive Officer, pursuant to Rule 13a-14(a) or 15d-14(a) of the Securities and Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.*

31.2 Certification of Katherine H. McDermott, Principal Financial Officer, pursuant to Rule 13a-14(a) or 15d-14(a) of the Securities and Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.*

32.1 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, executed by Richard S. Danforth, Principal Executive Officer and Katherine H. McDermott, Principal Financial Officer.*

101.INS XBRL Instance Document*

101.SCH XBRL Taxonomy Extension Schema Document*

101.CAL XBRL Taxonomy Extension Calculation Linkbase Document*

101.DEF XBRL Taxonomy Extension Definition Linkbase Document*

101.LAB XBRL Taxonomy Extension Label Linkbase Document*

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document*

*Filed concurrently herewith.

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.

LRAD CORPORATION

Date: February 8, 2017 By: /s/ KATHERINE H. MCDERMOTT
Katherine H. McDermott, Chief Financial Officer
(Principal Financial Officer)