GIGA TRONICS INC
Form 10-Q
November 10, 2015

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 the quarterly period ended **September 26, 2015**

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to

Commission File No. **0-12719**

GIGA-TRONICS INCORPORATED
(Exact name of registrant as specified in its charter)

California	**94-2656341**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
4650 Norris Canyon Road, San Ramon, CA 94583	**(925) 328-4650**
(Address of principal executive offices)	Registrant's telephone number, including area code

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

Yes [X] No [ ]

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§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 [X] No [ ]

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2).

Yes [ ] No [X]

There were a total of 6,725,281 shares of the Registrant’s Common Stock outstanding as of September 26, 2015.

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		32.2 Certification of CFO pursuant to Section 906 of Sarbanes-Oxley Act.

FORWARD-LOOKING STATEMENTS

This report on Form 10-Q contains forward-looking statements about Giga-tronics Incorporated (the "Company") for which it claims the protection of the safe harbor provisions contained in the Private Securities Litigation Reform Act of 1995. Examples of forward-looking statements include, but are not limited to: (i) projections of revenues, expenses, income or loss, earnings or loss per share, capital structure and other financial items; (ii) statements of plans, objectives and expectations of the Company or its management or board of directors, including those relating to products, revenue or cost savings; (iii) statements of future economic performance; and (iv) statements of assumptions underlying such statements. Words such as "believes", "anticipates", "expects", "intends", "targeted", "projected", "continue", "remain", "will", "should", "may" and other similar expressions are intended to identify forward-looking statements but are not the exclusive means of identifying such statements.

These forward-looking statements are based on Management's current knowledge and belief and include information concerning the Company's possible or assumed future financial condition and results of operations. A number of factors, some of which are beyond the Company's ability to predict or control, could cause future results to differ materially from those contemplated. These factors include but are not limited to risks related to (1) the Company's potential inability to obtain necessary capital to finance its operations; (2) the potential loss of certain future orders and sales if the Company is unable to regain certification of AS9100C compliance or similar assurance of quality control within a reasonable time; (3) probable delisting of the Company's common stock from the Nasdaq Capital Market; (4) the Company's ability to develop competitive products in a market with rapidly changing technology and standards; (5) risks related to customers' credit worthiness/profiles; (6) changes in the Company's credit profile and its ability to borrow; (7) a potential decline in demand for certain of the Company's products; (8) potential product liability claims; (9) the potential loss of key personnel; and (10) U.S. and international economic conditions. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also affect our business operations. The reader is directed to the Company's annual report on Form 10-K for the year ended March 28, 2015 or further discussion of factors that could affect the Company's business and cause actual results to differ materially from those expressed in any forward-looking statement made in this report. The Company undertakes no obligation to update any forward-looking statements in this report.

PART I – FINANCIAL INFORMATION

ITEM 1 - FINANCIAL STATEMENTS

GIGA-TRONICS INCORPORATED

CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(In thousands except share data)	September 26, 2015	March 28, 2015
Assets		
Current assets:		
Cash and cash-equivalents	$ 748	$ 1,170
Trade accounts receivable, net of allowance of $45, respectively	2,035	2,354
Inventories, net	4,367	3,365
Prepaid expenses and other current assets	273	373
Total current assets	7,423	7,262
Property and equipment, net	740	718
Other long term assets	100	74
Total assets	$ 8,263	$ 8,054
Liabilities and shareholders' equity		
Current liabilities:		
Line of credit	$ 950	$—
Current portion of long term debt	629	811
Accounts payable	1,877	973
Accrued payroll and benefits	738	678
Deferred revenue	1,374	1,127
Deferred rent	138	127
Capital lease obligations	42	69
Other current liabilities	432	501
Total current liabilities	6,180	4,286
Long term loan, net of discount	101	392
Derivative liability, at estimated fair value	294	252
Long term obligations - deferred rent	39	111
Long term obligations - capital lease	115	58
Total liabilities	6,729	5,099
Commitments and contingencies		
Shareholders' equity:		
Convertible preferred stock of no par value Authorized - 1,000,000 shares; Series A - designated 250,000 shares; no shares at September 26, 2015 and March 28, 2015 issued and outstanding	—	—
	2,911	2,911

Series B, C, D- designated 19,500 shares; 18,533.51 shares at September 26, 2015 and March 28, 2015 issued and outstanding; (liquidation value of $3,540 at September 26, 2015 and March 28, 2015)		
Common stock of no par value; Authorized - 40,000,000 shares; 6,725,281 shares at September 26, 2015 and 6,705,065 at March 28, 2015 issued and outstanding	20,489	19,975
Accumulated deficit	(21,866)	(19,931)
Total shareholders' equity	1,534	2,955
Total liabilities and shareholders' equity	$ 8,263	$ 8,054

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

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GIGA-TRONICS INCORPORATED

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

(In thousands except per share data)	Three Month Periods Ended		Six Month Periods Ended	
	September 26,	September 27,	September 26,	September 27,
	2015	**2014**	**2015**	**2014**
Net sales	$3,063	$ 5,110	$7,438	$ 9,618
Cost of sales	2,186	2,794	4,833	5,464
Gross margin	877	2,316	2,605	4,154
Operating expenses:				
Engineering	819	962	1,565	1,891
Selling, general and administrative	1,349	1,241	2,804	2,268
Total operating expenses	2,168	2,203	4,369	4,159
Operating income/(loss)	(1,291)	113	(1,764)	(5)
Gain/(loss) on adjustment of derivative liability to fair value	110	103	47	(90)
Other expense	—	—	—	(2)
Interest expense:				
Interest expense, net	(60)	(78)	(111)	(137)
Interest expense from accretion of loan discount	(63)	(45)	(105)	(69)
Total interest expense	(123)	(123)	(216)	(206)
Income / (loss) before income taxes	(1,304)	93	(1,933)	(303)
Provision for income taxes	2	—	2	47
Net income/(loss)	$(1,306)	$ 93	$(1,935)	$ (350)
Earnings/ (loss) per common share - basic	$(0.20)	$ 0.01	$(0.30)	$ (0.07)
Earnings/(loss) per common share - diluted	$(0.20)	$ 0.01	$(0.30)	$ (0.07)
Weighted average shares used in per share calculation:				
Basic	6,472	5,178	6,361	5,145
Diluted	6,472	5,720	6,361	5,145

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

GIGA-TRONICS INCORPORATED

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(In thousands)	Six Month Periods Ended September 26, 2015	September 27, 2014
Cash flows from operating activities:		
Net loss	$(1,935)	$ (350)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	145	153
Share based compensation	533	311
Loss on adjustment of derivative liability to fair value	(47)	90
Accretion of discounts on loan and warrant debt	105	69
Change in deferred rent	(61)	(49)
Changes in operating assets and liabilities	489	322
Net cash (used in) provided by operating activities	(771)	546
Cash flows from investing activities:		
Purchases of property and equipment	(89)	(16)
Net cash used in investing activities	(89)	(16)
Cash flows from financing activities:		
Proceeds from line of credit	950	5,975
Repayments of debt	(490)	—
Payments on capital leases	(44)	(101)
Proceeds from exercise of stock options	22	145
Proceeds from issuance of debt	—	500
Repayments of line of credit	—	(6,577)
Net cash provided by (used in) financing activities	438	(58)
(Decrease)/Increase in cash and cash-equivalents	(422)	472
Beginning cash and cash-equivalents	1,170	1,059
Ending cash and cash-equivalents	$748	$ 1,531
Supplementary disclosure of cash flow information:		
Cash paid for income taxes	$2	$ 2
Cash paid for interest	$81	$ 120
Supplementary disclosure of noncash financing activities:		
Equipment acquired under capital lease	$78	$ 49

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(1) Basis of Presentation

The condensed consolidated financial statements included herein have been prepared by Giga-tronics Incorporated (the "Company"), pursuant to the rules and regulations of the Securities and Exchange Commission. The consolidated results of operations for the interim periods shown in this report are not necessarily indicative of results to be expected for the fiscal year. In the opinion of management, the information contained herein reflects all adjustments (consisting of normal recurring entries) necessary to make the consolidated results of operations for the interim periods a fair statement of such operations. For further information, refer to the consolidated financial statements and footnotes thereto, included in the Annual Report on Form 10-K, filed with the Securities and Exchange Commission for the year ended March 28, 2015.

Principles of Consolidation The consolidated financial statements include the accounts of Giga-tronics and its wholly-owned subsidiary. All significant intercompany balances and transactions have been eliminated in consolidation.

Derivatives The Company's derivatives are valued in accordance with US Generally Accepted Accounting Principles in accordance with Financial Accounting Standards Board ("FASB") Accounting Standard Codification ("ASC") Topic 820, Fair Value Measurements and Disclosures. Changes in fair values are reported in earnings as gain or loss on adjustment of derivative liability to fair value.

New Accounting Standards In July 2015, the FASB issued ASU No, 2015-11, *Inventory (Topic 330): "Simplifying the Measurement of Inventory"*. Topic 330, *Inventory*, currently requires an entity to measure inventory at the lower of cost or market. Market could be replacement cost, net realizable value, or net realizable value less an approximately normal profit margin. The amendments do not apply to inventory that is measured using last-in, first-out (LIFO) or the retail inventory method. The amendments apply to all other inventory, which includes inventory that is measured using first-in, first-out (FIFO) or average cost. An entity should measure in scope inventory at the lower of cost and net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. Subsequent measurement is unchanged for inventory measured using LIFO or the retail inventory method. The amendments more closely align the measurement of inventory in GAAP with the measurement of inventory in International Financial Reporting Standards. For public business entities, the amendments are effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. The amendments should be applied prospectively with earlier application permitted as of the beginning of an interim or annual reporting period. The Company is currently evaluating the impact this accounting standard update may have on its financial statements.

(2) Going Concern and Management's Plan

The Company incurred net losses of $1.3 million for the second quarter of fiscal 2016 and $1.9 million for the first half of fiscal 2016, which have contributed to an accumulated deficit of $21.9 million as of September 26, 2015.

In the second quarter of fiscal 2016 the Company experienced delays in shipments of its legacy Giga-tronics Division test and measurement equipment and Microsource radar filter components due to late arriving materials from suppliers. The Company also experienced a delay in shipments for the Giga-tronics Division's new Advanced Signal Generator product due to technical issues encountered prior to shipment. These delays in shipments have significantly contributed to a decrease in working capital of $3.0 million from March 28, 2015 to $1.2 million at September 26, 2015.

Many of the planned second quarter of fiscal 2016 shipments that were delayed, shipped early in the third quarter of fiscal 2016, including three units of the new Advanced Signal Generator product. The new Advanced Signal Generator product has now shipped to several customers, but potential delays in shipping volume quantities, or longer than anticipated sales cycles, could significantly contribute to additional future losses.

These matters raise substantial doubt as to the ability of the Company to continue as a going concern.

To address this matter, the Company's management has taken several actions to provide additional liquidity and reduce costs and expenses going forward. These actions are described in the following paragraphs.

In the first quarter of fiscal 2016, the Company's Microsource division received a $3.0 million order ("Ongoing Production Order") for its high performance YIG filters from a major aerospace company extending its ongoing production of the filters for the aerospace company. The Company started shipments for this order in the second quarter of fiscal 2016, and expects to complete it in the fourth quarter of fiscal 2016.

Also in the first quarter of fiscal 2016, the Company's the Microsource business unit also finalized a multiyear $10.0 million YIG production order ("YIG Production Order"). The Company expects to start shipping the YIG Production Order in the fall of 2016.

On June 1, 2015 the Company entered into a two year $2.5 million Revolving Accounts Receivable Line of Credit agreement with Bridge Bank N.A ("Bridge Bank"). The Bridge Bank credit facility replaced the line of credit with Silicon Valley Bank ("SVB"), which expired April 15, 2015. The $2.5 million credit facility includes $500,000 of available borrowing not based on accounts receivables (see Note 11, Accounts Receivable Line of Credit).

In October 2015 the Company received a $1.4 million order for the new Advanced Signal Generator product, which the Company expects to fulfill in the current fiscal year after achieving ISO9001 certification. With several customer shipments, new customer orders received, and the start of similar units in production for orders in backlog and potential future sales to customers, the Advanced Signal Generation System has made progress towards becoming a viable commercial product. The Company could experience longer than anticipated sales cycles or delays in production and shipping volume quantities of the Advanced Signal Generation System. Also, the Company has recently lost, and is seeking to regain its AS9100C Certification on its Supplier Quality Management System. Assuming the Company can regain AS9100C or ISO9001 certification (a requirement of certain customers) within a reasonable period of time, the Company believes the Advanced Signal Generation System will significantly contribute to the Company's long term success.

To assist with the upfront purchases of inventory required for future product deliveries, the Company entered into an advance payment arrangement with a large customer, whereby the customer reimburses the Company for raw material purchases prior to the shipment of the finished products. In the first two quarters of fiscal 2016 the Company entered into advance payment arrangements totaling $1.1 million, and during the first two quarters of fiscal 2015 the Company entered into $1.3 million of advance payment arrangements. The Company will continue to seek similar terms in future agreements with this customer and other customers.

Management will continue to review all aspects of the business in an effort to improve cash flow and reduce costs and expenses, while continuing to invest, to the extent possible, in new product development for future revenue streams.

Management will also continue to seek additional working capital through debt, equity financing or possible product line sales, however there are no assurances that such financings or sales will be available at all, or on terms acceptable to the Company.

The current year loss has had a significant negative impact on the financial condition of the Company and raise substantial doubt about the Company's ability to continue as a going concern. The Consolidated Financial Statements have been prepared assuming the Company will continue as a going concern and do not include any adjustments that might result if the Company were unable to do so.

(3) Revenue Recognition

The Company records revenue when there is persuasive evidence of an arrangement, delivery has occurred, the price is fixed and determinable, and collectability is reasonably assured. This occurs when products are shipped or the customer accepts title transfer. If the arrangement involves acceptance terms, the Company defers revenue until product acceptance is received. The Company limits the amount of revenue recognition for delivered elements to the amount that is not contingent on the future delivery of products or services, future performance obligations or subject to customer-specified return or refund privileges. The Company evaluates each deliverable in an arrangement to determine whether they represent separate units of accounting. On certain large development contracts, revenue is recognized upon achievement of substantive milestones. Determining whether a milestone is substantive is a matter of judgment and that assessment is performed only at the inception of the arrangement. The consideration earned from the achievement of a milestone must meet all of the following for the milestone to be considered substantive:

a. It is commensurate with either of the following:

1. The Company’s performance to achieve the milestone.

2. The enhancement of the value of the delivered item or items as a result of a specific outcome resulting from the Company's performance to achieve the milestone.

b. It relates solely to past performance.

c. It is reasonable relative to all of the deliverables and payment terms (including other potential milestone consideration) within the arrangement.

Milestones are agreed upon with the customer prior to the start of the contract and some milestones will be tied to product shipping while others will be tied to design review. In fiscal 2015 the Company’s Microsource business unit received a $6.5 million order from a major aerospace company for non-recurring engineering services to develop a variant of its high performance fast tuning YIG filters for an aircraft platform and to deliver a limited number of flight-qualified prototype hardware units (the “NRE Order”) which is being accounted for on a milestone basis. The Company considered factors such as estimated completion dates and product acceptance of the order prior to accounting for the NRE Order as milestone revenue. During the three and six month periods ended September 26, 2015 and September 26, 2014, revenue recognized on a milestone basis were $18,000 and $710,000, and $1.3 million and $2.9 million, respectively.

On certain contracts with several of the Company’s significant customers, the Company receives payments in advance of manufacturing. Advanced payments are recorded as deferred revenue until the revenue recognition criteria described above has been met.

Accounts receivable are stated at their net realizable value. The Company has estimated an allowance for uncollectable accounts based on analysis of specifically identified accounts, outstanding receivables, consideration of the age of those receivables, the Company's historical collection experience, and adjustments for other factors management believes are necessary based on perceived credit risk.

The Company provides for estimated costs that may be incurred for product warranties at the time of shipment. The Company's warranty policy generally provides twelve to eighteen months depending on the customer. The estimated cost of warranty coverage is based on the Company's actual historical experience with its current products or similar products. For new products, the required reserve is based on historical experience of similar products until such time as sufficient historical data has been collected on the new product. Adjustments are made as new information becomes available.

(4) Inventories

Inventories consisted of the following:

(In thousands)	September 26, 2015	March 28, 2015
Raw materials	$ 2,016	$ 1,631
Work-in-progress	2,176	1,598
Finished goods	87	15
Demonstration inventory	88	121
Total	$ 4,367	$ 3,365

(5) Earnings/ Loss Per Share

Basic earnings (loss) per share (EPS) is calculated by dividing net income or loss by the weighted average common shares outstanding during the period. Diluted EPS reflects the net incremental shares that would be issued if unvested restricted shares became vested and dilutive outstanding stock options were exercised, using the treasury stock method. In the case of a net loss, it is assumed that no incremental shares would be issued because they would be antidilutive. In addition, certain options are considered antidilutive because assumed proceeds from exercise price, related tax benefits and average future compensation were greater than the weighted average number of options outstanding multiplied by the average market price during the period. The shares used in per share computations are as follows:

(In thousands except per share data)	Three Month Periods Ended		Six Month Periods Ended	
	September 26, 2015	September 27, 2014	September 26, 2015	September 27, 2014
Net income/(loss) as reported	$(1,306)	$ 93	$(1,935)	$ (350)
Net income attributable to participating securities	—	(25)	—	
Net income/(loss)	$(1,306)	$ 68	$(1,935)	$ (350)
Weighted average:				
Common shares outstanding	6,472	5,178	6,361	5,145
Potential common shares	—	542	—	—
Common shares assuming dilution	6,472	5,720	6,361	5,145
Net earnings/ loss per share - basic	$(0.20)	$ 0.01	$(0.30)	$ (0.07)
Net earnings/ loss per share - diluted	$(0.20)	$ 0.01	$(0.30)	$ (0.07)
Stock options not included in computation that could potentially dilute EPS in the future	1,636	957	1,636	1,770
Restricted stock awards not included in computation that could potentially dilute EPS in the future	245	187	245	237
Convertible preferred stock not included in computation that could potentially dilute EPS in the future	1,853	—	1,853	1,853
Warrants not included in computation that could potentially dilute EPS in the future	1,353	—	1,353	1,277

The stock options, restricted stock, convertible preferred stocks and warrants not included in the computation of diluted earnings per share (EPS) for the three and six month periods ended September 26, 2015 and September 27, 2014 is a result of the Company’s net loss and, therefore, the effect of these instruments would be anti-dilutive.

(6) Share Based Compensation

The Company has established the 2005 Equity Incentive Plan, which provide for the granting of options and restricted stock for up to 2,850,000 shares of common stock at 100% of fair market value at the date of grant, with each grant requiring approval by the Board of Directors of the Company. Options granted generally vest in one or more installments in a four or five year period and must be exercised while the grantee is employed by the Company or within a certain period after termination of employment. Options granted to employees shall not have terms in excess of 10 years from the grant date. Holders of options may be granted stock appreciation rights (SARs), which entitle them to surrender outstanding awards for a cash distribution under certain changes in ownership of the Company, as defined in the stock option plan. As of September 26, 2015, no SARs have been granted under the option plan. As of September 26, 2015, the total number of shares of common stock available for issuance is 947,702. All outstanding options have either a five year or a ten year life. The Company records compensation cost associated with share-based compensation equivalent to the estimated fair value of the awards over the requisite service period. There were no options granted in the second quarter of fiscal 2016 and for the first half of fiscal 2016. There were 229,500 options granted in the second quarter of fiscal 2015 and for the first half of fiscal 2015 with weighted average grant date fair values of $1.75 per share.

In calculating compensation related to stock option grants, the fair value of each stock option is estimated on the date of grant using the Black-Scholes-Merton option-pricing model and the following weighted average assumptions:

	Three Month Periods Ended			**Six Month Periods Ended**		
	September 26, 2015	**September 27, 2014**		**September 26, 2015**	**September 27, 2014**	
Dividend yield	None	None		None	None	
Expected volatility	None	91.47	%	None	91.47	%
Risk-free interest rate	None	1.66	%	None	1.66	%
Expected term (years)	None	8.36		None	8.36	

The computation of expected volatility used in the Black-Scholes-Merton option-pricing model is based on the historical volatility of the Company’s share price. The expected term is estimated based on a review of historical employee exercise behavior with respect to option grants. The risk-free interest rate is based on the U.S. Treasury rates with maturity similar to the expected term of the option on the date of grant.

A summary of the changes in stock options outstanding for the six month period ended September 26, 2015 and the fiscal year ended March 28, 2015 is as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Terms (Years)	Aggregate Intrinsic Value (in thousands)
Outstanding at March 29, 2014	1,738,750	$ 1.53	6.8	$ 113
Granted	306,500	2.01		
Exercised	90,000	1.80		
Forfeited / Expired	228,275	1.81		
Outstanding at March 28, 2015	1,726,975	$ 1.57	6.9	$ 219
Granted	—	—		
Exercised	12,000	1.85		
Forfeited / Expired	78,500	2.40		
Outstanding at September 26, 2015	1,636,475	$ 1.53	7.2	$ 4
Exercisable at September 26, 2015	912,975	$ 1.46	6.8	$ 2
At September 26, 2015, expected to vest in the future	1,473,945	$ 1.51	7.1	$ 3

As of September 26, 2015, there was $586,000 of total unrecognized compensation cost related to non-vested options. That cost is expected to be recognized over a weighted average period of 2.7 years. There were 252,650 options and 98,150 options that vested during the quarter ended September 26, 2015 and September 27, 2014, respectively. The total grant date fair value of options vested during the quarters ended September 26, 2015 and September 27, 2014 was $243,000 and $104,000, respectively. There were 291,150 and 159,400 options that vested during the six month period ended September 26, 2015 and September 27, 2014, respectively. The total grant date fair value of options vested during the six month periods ended September 26, 2015 and September 27, 2014 was $285,000 and $183,000, respectively. No shares were exercised in the three month period ended September 26, 2015 and 64,000 shares were exercised in the three month period ended September 27, 2014. Options of 12,000 shares were exercised in the six month period ended September 26, 2015 and 76,500 shares were exercised in the six month period ended September 27, 2014. Share based compensation cost recognized in operating results for the three month periods ended September 26, 2015 and September 27, 2014 totaled $109,000 and $96,000, respectively. Share based compensation cost recognized in operating results for the six month periods ended September 26, 2015 and September 27, 2014 totaled $223,000 and $177,000, respectively.

Restricted Stock

No restricted awards were granted in the second quarter or the first half of fiscal 2016. The Company granted 187,000 shares of restricted stock during the first half of fiscal 2015 to the members of the Board of Directors in lieu of cash compensation for services to be performed in fiscal 2015. These restricted stock awards fully vested in the fiscal quarter ended September 26, 2015. The weighted average grant date fair value was $2.47. The Company granted 50,000 shares of restricted stock outside the 2005 Plan in fiscal 2013 that vested in the first quarter of fiscal 2016. The restricted stock awards are considered fixed awards as the number of shares and fair value at the grant date is amortized over the requisite service period net of estimated forfeitures.

As of September 26, 2015, there was $149,000 of total unrecognized compensation cost related to restricted awards. That cost is expected to be recognized over a weighted average period of 0.5 years. Compensation cost was recognized for the restricted and unrestricted stock awards for the three and six month periods ended September 26, 2015 totaling $89,000 and $220,000, respectively. Compensation cost was recognized for the restricted and unrestricted stock awards for the three and six month periods ended September 27, 2014 totaling $131,000 and $134,000, respectively.

A summary of the changes in non-vested restricted stock awards outstanding at September 26, 2015 and at March 28, 2015 is as follows:

	Shares	Wt. Avg. Grant Date Fair Value
Non-Vested at March 29, 2014	121,500	$ 1.39
Granted	432,000	2.11
Vested	71,500	1.53
Forfeited or cancelled	—	—
Non-Vested at March 28, 2015	482,000	$ 2.02
Granted	—	—
Vested	237,000	2.02
Forfeited or cancelled	—	—
Non-Vested at September 26, 2015	245,000	$ 1.84

(7) Significant Customer and Industry Segment Information

The Company has two reportable segments: Giga-tronics Division and Microsource.

Giga-tronics Division produces a broad line of test and measurement equipment used in the development, test and maintenance of wireless communications products and systems, flight navigational equipment, electronic defense systems and automatic testing systems and designs, manufactures, and markets a line of switching devices that link together many specific purpose instruments that comprise automatic test systems. These products are used primarily in the design, production, repair and maintenance of commercial telecommunications, radar, and electronic warfare equipment. Microsource develops and manufactures a broad line of YIG (Yttrium, Iron, Garnet) tuned oscillators, filters and microwave synthesizers, which are used by its customers in operational applications and in manufacturing a wide variety of microwave instruments and devices.

The tables below present information for the three and six month periods ended September 26, 2015 and September 27, 2014.

(In thousands)	Sep. 26, 2015	Three Month Periods Ended Sep. 26, 2015		Sep. 27, 2014	Three Month Periods Ended Sep. 27, 2014	
	Assets	Net Sales	Net Income (Loss)	Assets	Net Sales	Net Income (Loss)
Giga-tronics Division	$ 5,966	$2,099	$(1,609)	$5,834	$2,915	$(1,054)
Microsource	2,297	964	303	2,644	2,195	1,147
Total	$ 8,263	$3,063	$(1,306)	$8,478	$5,110	$93

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(In thousands)	**Sep. 26, 2015**	**Six Month Periods Ended Sep. 26, 2015**		**Sep. 27, 2014**	**Six Month Periods Ended Sep. 27, 2014**	
	Assets	**Net Sales**	**Net Income (Loss)**	**Assets**	**Net Sales**	**Net Income (Loss)**
Giga-tronics Division	$5,966	$4,216	$(3,254)	$ 5,834	$4,617	$(2,696)
Microsource	2,297	3,222	1,319	2,644	5,001	2,346
Total	$8,263	$7,438	$(1,935)	$ 8,478	$9,618	$(350)

During the second quarter of fiscal 2016, two customers accounted for 62% of the Company's consolidated revenues. One of the customers accounted for 31% of the Company's consolidated revenue and was included in the Giga-tronics Division. A second customer accounted for another 31% of the Company's consolidated revenue for the three months ended September 26, 2015 and was primarily included in the Microsource segment. A third customer accounted for 12% of the Company's consolidated revenue for the three months ended September 26, 2015 and was primarily included in the Giga-tronics Division. During the second quarter of fiscal 2015, one customer accounted for 37% of the Company's consolidated revenue and was primarily included in the Giga-tronics Division. A second customer accounted for 26% and was included in the Microsource segment.

During the first half of fiscal 2016, one customer accounted for 31% of the Company's consolidated revenues and was primarily included in the Microsource segment. A second customer accounted for 20% of the Company's consolidated revenue for the six months ended September 26, 2015 and was included in the Giga-tronics Division. A third customer accounted for 10% of the Company's consolidated revenue for the six months ended September 26, 2015 and was primarily included in the Microsource segment. One customer accounted for 31% of the Company's consolidated revenues for the six months ended September 27, 2014 and was primarily included in the Microsource segment. A second customer accounted for 27% of the Company's consolidated revenues for the six months ended September 27, 2014 and was included in the Giga-tronics Division.

(8) Income Taxes

The Company accounts for income taxes using the asset and liability method as codified in Topic 740. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry-forwards.

The Company recorded $2,000 tax expense for the three months and six months ended September 26, 2015. The Company's tax expense for the three and six months ended September 27, 2014 was $47,000. The effective tax rate for

the three months and six months ended September 26, 2015 and September 27, 2014 was 0% and 12% primarily due to a valuation allowance recorded against the net deferred tax asset balance.

As of September 26, 2015, the Company had recorded $93,000 for unrecognized tax benefits related to uncertain tax positions. The unrecognized tax benefit is netted against the non-current deferred tax asset on the Consolidated Balance Sheet. The Company does not expect the liability for unrecognized tax benefits to change materially within the next 12 months. The Company does have a California Franchise Tax Board audit that is currently in process. The Company is working with the California Franchise Tax Board to resolve all audit issues and does not believe any material taxes, penalties and fees are due. However, as a result of the ongoing examination, the Company recorded an estimated associated tax liability of $45,000 in the first quarter of fiscal 2015

(9) Warranty Obligations

The Company records a provision in cost of sales for estimated warranty obligations at the date products are sold. Adjustments are made as new information becomes available. The following provides a reconciliation of changes in the Company's warranty reserve. The Company provides no other guarantees.

(In thousands)	Three Months Ended		Six Months Ended	
	September 26, 2015	September 27, 2014	September 26, 2015	September 27, 2014
Balance at beginning of period	$75	$ 63	$76	$ 61
Provision, net	9	17	26	27
Warranty costs incurred	(17)	(7)	(35)	(15)
Balance at end of period	$67	$ 73	$67	$ 73

(10) Fair Value

Fair Value Pursuant to the accounting guidance for fair value measurement and its subsequent updates, fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (i.e., the "exit price") in an orderly transaction between market participants at the measurement date. The accounting guidance establishes a hierarchy for inputs used in measuring fair value that minimizes the use of unobservable inputs by requiring the use of observable market data when available. Observable inputs are inputs that market participants would use in pricing the asset or liability based on active market data. Unobservable inputs are inputs that reflect the assumptions market participants would use in pricing the asset or liability based on the best information available in the circumstances.

The fair value hierarchy is broken down into the three input levels summarized below:

- *Level 1* —Valuations are based on quoted prices in active markets for identical assets or liabilities and readily accessible by us at the reporting date. Examples of assets and liabilities utilizing Level 1 inputs are certain money market funds, U.S. Treasuries and trading securities with quoted prices on active markets.

- *Level 2* —Valuations based on inputs other than the quoted prices in active markets that are observable either directly or indirectly in active markets. Examples of assets and liabilities utilizing Level 2 inputs are U.S. government agency bonds, corporate bonds, commercial paper, certificates of deposit and over-the- counter derivatives.

- *Level 3* —Valuations based on unobservable inputs in which there are little or no market data, which require us to develop our own assumptions.

The carrying amounts of the Company's cash and cash-equivalents and line of credit approximate their fair values at each balance sheet date due to the short-term maturity of these financial instruments. The fair values of term debt are based on the present value of expected future cash flows and assumptions about current interest rates and the creditworthiness of the Company (Level 3). At September 26, 2015 and March 28, 2015, the carrying amounts of the Company's term debt totaled $730,000 and $1.1 million respectively and the estimated fair value totaled $725,000 and $1.2 million respectively. The fair value was calculated using a discounted cash flow model and utilized an 18% discount rate which is commensurate with market rates given the remaining term, principal repayment schedule, the Company's creditworthiness and outstanding loan balance.

The Company's derivative warrant liability is measured at fair value on a recurring basis and is categorized as Level 3 in the fair value hierarchy. The derivative warrant liability is valued using the Monte Carlo simulation model, using the following assumptions as of September 26, 2015: (i) the remaining expected life of 3.5 years, (ii) the Company's historical volatility rate of 105.7%, (iii) risk-free interest rate of 1.18%, and (iv) a discount rate of eighteen percent.

The Company's assets and liabilities that are recognized and measured at fair value on a recurring basis are as follows:

Fair Value Measurements as of September 26, 2015 (In Thousands):

	Level 1	Level 2	Level 3
Warrant Liability	$ —	—	$ 294
Total	$ —	—	$ 294

Fair Value Measurements as of March 28, 2015 (In Thousands):

	Level 1	Level 2	Level 3
Warrant Liability	$ —	—	$ 341
Total	$ —	$ —	$ 341

There were no transfers between Level 1, Level 2 or Level 3 for the three and six month periods ended September 26, 2015 and March 28, 2015.

The table below summarizes changes in gains and losses recorded in earnings for Level 3 assets and liabilities that are still held at September 26, 2015:

(In thousands)	**Three Months Ended September 26, 2015**	**Three Months Ended September 27, 2014**	**Six Months Ended September 26, 2015**	**Six Months Ended September 27, 2014**
Warrant liability at beginning of period	$404	$ 444	$341	$ 251
Gains (recorded in other income/expense)	(110)	(103)	(47)	—
Losses (recorded in other income/expense)	—	—	—	90
Warrant liability at end of period	$294	$ 341	$294	$ 341

There were no assets measured at fair value on a recurring basis and there were no assets or liabilities measured on a non-recurring basis at September 26, 2015 and March 28, 2015.

The following table presents quantitative information about recurring Level 3 fair value measurements at September 26, 2015 and March 28, 2015:

September 26, 2015	Valuation Technique(s)	Unobservable Input	
Warrant liability	Monte Carlo	Discount rate	18%

March 28, 2015	Valuation Techniques(s)	Unobservable Input	
Warrant liability	Discounted cash flow	Discount rate	18%

The discount rate of eighteen percent is management's estimate of the current cost of capital given the Company's credit worthiness. A significant increase in the discount rate would significantly decrease the fair value, but the magnitude of this decrease would be less significant in a scenario where the Company's stock price is significantly higher than the exercise price since the holder's option to take a cash payment at maturity represents a smaller component of the total fair value when the Company's stock price is higher. The Monte Carlo simulation model simulated the Company's stock price through the maturity date of March 31, 2019. At the end of the simulated period, the value of the warrant was determined based on the greater of (1) the net share settlement value, (2) the net exercise value, or (3) the fixed cash put value.

(11) Accounts Receivable Line of Credit

On June 1, 2015 the Company entered into a $2.5 million Revolving Accounts Receivable Line of Credit agreement with Bridge Bank. The credit facility agreement replaced the line of credit with SVB which expired April 15, 2015. The agreement provides for a maximum borrowing capacity of $2.5 million of which $2.0 million is subject to a borrowing base calculation and $500,000 is non-formula based.

The loan is secured by all assets of the Company including intellectual property and general intangibles and provides for a borrowing capacity equal to 80% of eligible accounts receivable. The loan matures on May 6, 2017 and bears an interest rate, equal to 1.5% over the bank's prime rate of interest (which was 3.25% at the date of closing resulting in an interest rate of 4.75%). Interest is payable monthly with principal due upon maturity. The Company paid a commitment fee of $12,500, and an additional $12,500 is due on the first anniversary of the loan closing. The loan agreement contains financial and non-financial covenants that are customary for this type of lending and includes a covenant to maintain an asset coverage ratio of at least 135% (defined as unrestricted cash and cash equivalents maintained with Bridge Bank, plus eligible accounts receivable aged less than 90 days from the invoice date, divided by the total amount of outstanding principal of all obligations under the loan agreement). As of September 26, 2015, the Company was in compliance with all the financial covenants under the agreement. The line of credit requires a lockbox arrangement, which provides for receipts to be swept daily to reduce borrowings outstanding at the discretion of Bridge Bank. This arrangement, combined with the existence of the subjective acceleration clause in the line of credit agreement, necessitates the line of credit be classified as a current liability on the balance sheet. The

acceleration clause allows for amounts due under the facility to become immediately due in the event of a material adverse change in the Company’s business condition (financial or otherwise), operations, properties or prospects, or ability to repay the credit based on the lender's judgment. As of September 26, 2015, the Company’s total outstanding borrowings and remaining borrowing capacity under the Bridge Bank line of credit were $950,000 and $1.0 million, respectively.

(12) Term Loan, Revolving Line of Credit and Warrants

On March 13, 2014 the Company entered into a three year, $2.0 million term loan agreement with PFG under which the Company received $1.0 million on March 14, 2014. Pursuant to the agreement, the Company had the ability to borrow an additional $1.0 million following the Company’s achievement of certain performance milestones which included achieving $7.5 million in net sales during the first half of fiscal 2015 and two consecutive quarters of net income greater than zero during fiscal 2015.

On June 16, 2014, the Company amended its loan agreement with PFG (the “Amendment”). Under the terms of the Amendment, PFG made a revolving credit line available to Giga-tronics in the amount of $500,000, and the Company borrowed the entire amount on June 17, 2014. The revolving line had a 33 month term. The Amendment also reduced the Company’s potential future borrowing availability under the PFG Loan agreement from $1.0 million to $500,000. The interest on the PFG revolving credit line was fixed, calculated on a daily basis at a rate of 12.50% per annum. The Company was allowed to prepay the loan at any time prior to its March 13, 2017 maturity date without a penalty. Beginning in October 2014, PFG had the right to convert the $500,000 revolving loan into a term loan and require principal payments to be amortized over the remaining loan term. On April 25, 2015, PFG exercised this right, and fully amortizing principal and interest payments began in May 2015.

On June 3, 2015, and following the Company’s new line of credit agreement with Bridge Bank (see Note 11, Accounts Receivable Line of Credit), the Company’s loan agreement with PFG was further amended (the “Second Amendment”). The Second Amendment cancelled the Company’s $500,000 of borrowing availability under the June 2014 Amendment and required the Company to pay PFG $150,000 towards its existing $500,000 outstanding balance under the revolving line of credit, in which the Company paid in July 2015. The Company also agreed to pay PFG an additional $10,000 per month towards its remaining credit line balance until repaid, followed by like payments towards its term loan balance until repaid. The Company expects to pay off the credit line by April 1, 2016.

Interest on the initial $1.0 million term loan is fixed at 9.75% and required monthly interest only payments during the first six months of the agreement followed by monthly principal and interest payments over the remaining 30 months. The Company may prepay the loan at any time prior to maturity by paying all future scheduled principal and interest payments. As of September 26, 2015, the Company’s total outstanding principal balance under the PFG term loan was $600,000.

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As of September 26, 2015, the Company's total outstanding principal balance under the revolving credit line loan was $208,000.

The PFG loan is secured by all of the assets of the Company under a lien that is junior to the Bridge Bank debt agreement described in Note 11, and limits borrowing under the Bridge Bank credit line to $2.5 million. The Company paid a loan fee of $30,000 upon the initial draw ("First Draw"), $15,000 for the June 2014 Amendment and $5,000 for the Second Amendment. The loan fees paid are recorded as prepaid expenses and amortized to interest expense over the remaining term of the PFG amended loan agreement.

The PFG loan agreement contains financial covenants associated with the Company achieving minimum quarterly net sales and maintaining a minimum monthly shareholders' equity. In the event of default by the Company, all or any part of the Company's obligations to PFG could become immediately due. As of the quarter ended September 26, 2015, the Company was not in compliance with the revenue financial covenant under the agreement. As a result, the Company notified PFG of the non-compliance and PFG provided the Company a waiver on October 8, 2015 related to the non-compliance which required a $10,000 cash payment by the Company. The Company paid this amount on October 13, 2015.

The loan agreement also provided for the issuance of warrants convertible into 300,000 shares of the Company's common stock, of which 180,000 were exercisable upon receipt of the initial $1.0 million from the First Draw, and 80,000 became exercisable with the Amendment. The Second Amendment terminated the additional 40,000 warrants that would have become exercisable as part of cancelling the remaining $500,000 that was available under the Amendment. Each warrant issued under the loan agreement has a term of five years from the First Draw and an exercise price of $1.42 which was equal to the average NASDAQ closing price of the Company's common stock for the ten trading days prior to the First Draw.

If the warrants are not exercised before expiration on March 13, 2019, the Company would be required to pay PFG $150,000 and $67,000 as settlement for warrants associated with the First Draw and the Amendment, respectively. The warrants could be settled for cash at an earlier date in the event of any acquisition or other change in control of the Company, future public issuance of Company securities or liquidation (or substantially similar event) of the Company. The Company currently has no plans for any of the aforementioned events, and as a result, the cash payment date is estimated to be the expiration date unless warrants are exercised before then. The warrants have the characteristics of both debt and equity and are accounted for as a derivative liability measured at fair value each reporting period with the change in fair value recorded in earnings. The initial fair value of the warrants associated with the First Draw and Amendment were $128,000 and $123,000, respectively.

As of September 26, 2015, the estimated fair values of the derivative liabilities associated with the warrants issued in connection with the First Draw and Amendment were $176,000 and $118,000, respectively, for a combined value of $294,000. The change in the fair value of the warrant liability totaled $110,000 for the three month period ended

September 26, 2015 and is reported in the accompanying statement of operations as a gain on adjustment of derivative liability to fair value.

The initial $1.0 million in proceeds under the term loan agreement were allocated between the PFG Loan and the warrants based on their relative fair values on the date of issuance which resulted in initial carrying values of $822,000 and $178,000, respectively. The resulting discount of $178,000 on the PFG Loan is being accreted to interest expense under the effective interest method over the three-year term of the PFG Loan.

The proceeds from the $500,000 credit line issued in connection with the Amendment were allocated between the PFG Loan and the warrants based on their relative fair values on the date of issuance which resulted in initial carrying values of $365,000 and $135,000, respectively. The resulting discounts of $135,000 on the PFG Loan is being accreted to interest expense under the effective interest method over the remaining term of the PFG Loan.

For the three month periods ended September 26, 2015 and September 27, 2014, the Company recorded accretion of discount expense associated with the PFG Loan of $63,000 and $45,000 respectively. For the six month period ended September 26, 2015 and September 27, 2014, the Company recorded accretion of discount expense associated with the PFG Loan of $105,000 and $69,000 respectively.

(13) Series B, C, D Convertible Voting Perpetual Preferred Stock and Warrants

On November 10, 2011, the Company received $2,199,000 in cash proceeds from Alara Capital AVI II, LLC, a Delaware limited liability company (the “Investor”), an investment vehicle sponsored by Active Value Investors, LLC, under a Securities Purchase Agreement entered into on October 31, 2011. Under the terms of the Securities Purchase Agreement, the Company issued 9,997 shares of its Series B Convertible Voting Perpetual Preferred Stock (“Series B Preferred Stock”) to the Investor at a price of $220 per share. The Company has recorded $2.0 million as Series B Preferred Stock on the consolidated balance sheet which is net of stock offering costs of approximately $202,000 and represents the value attributable to both the convertible preferred stock and warrants issued to the Investor. After considering the value of the warrants, the effective conversion price of the preferred stock was greater than the common stock price on date of issue and therefore no beneficial conversion feature was present.

On February 19, 2013, the Company entered into a Securities Purchase Agreement pursuant to which it agreed to sell 3,424.65 shares of its Series C Convertible Voting Perpetual Preferred Stock (“Series C Preferred Stock”) to the Investor, for aggregate consideration of $500,000, which is approximately $146.00 per share. The Company has recorded $457,000 as Series C Preferred Stock on the consolidated balance sheet, which is net of stock offering costs of approximately $43,000.After considering the reduction in the value of the warrant, the effective conversion price of the preferred stock was greater than the common stock price on the date of issue and therefore no beneficial conversion feature was present.

On July 8, 2013 the Company received $817,000 in net cash proceeds from the Investor under a Securities Purchase Agreement. The Company sold to the Investor 5,111.86 shares of its Series D Convertible Voting Perpetual Preferred Stock (Series D Preferred Stock) and a warrant to purchase up to 511,186 additional shares of common stock at the price of $1.43 per share. The allocation of the $858,000 in gross proceeds from issuance of Series D Preferred Stock based on the relative fair values resulted in an allocation of $498,000 (which was recorded net of $41,000 of issuance costs) to Series D Preferred Stock and $360,000 to Common Stock. In addition, because the effective conversion rate based on the $498,000 allocated to Series D Preferred Stock was $0.97 per common share which was less than the Company’s stock price on the date of issuance, a beneficial conversion feature was present at the issuance date. The beneficial conversion feature totaled$238,000 and was recorded as an increase of common stock and an increase to accumulated deficit.

Each share of Series B, Series C and Series D Preferred Stock is convertible into one hundred shares of the Company’s common stock. The investor also held warrants to purchase 1,017,405 shares at an exercise price of $1.43 per share which were exercised in February and May 2015 as discussed in Note 14, Exercise of Series C and Series D Warrants.

The table below presents information as of September 26, 2015 and March 28, 2015.

Preferred Stock as of September 26, 2015 and March 28, 2015

	Designated Shares	Shares Issued	Shares Outstanding	Liquidation Preference (in thousands)
Series B	10,000.00	9,997.00	9,997.00	$ 2,309
Series C	3,500.00	3,424.65	3,424.65	500
Series D	6,000.00	5,111.86	5,111.86	731
Total	19,500.00	18,533.51	18,533.51	$ 3,540

(14) Exercise of Series C and Series D Warrants

On February 16, 2015, the Company entered into a Securities Purchase Agreement and Warrant Agreement with Alara Capital AVI II, LLC in which the Company received total gross cash proceeds of approximately $1.5 million. Funds were received from Alara in separate closings dated February 16, 2015 and February 23, 2015 in which Alara exercised a total of 1,002,818 of its existing Series C and Series D warrants to purchase common shares, all of which had an exercise price of $1.43 per share for total cash proceeds of $1,434,000, which was recorded net of $42,000 of stock issuance costs. As part of the consideration for this exercise, the Company sold to Alara two new warrants ("new Warrants") to purchase an additional 898,634 and 194,437 common shares at an exercise price of $1.78 and $1.76 per share, respectively, for a total purchase price of $137,000 or $0.125 per share, The new warrants have a term of five years and may be paid in cash or through a cashless net share settlement. The Company and Alara amended the remaining 14,587 warrants as part of the February closings. On May 14, 2015, Alara exercised the remaining 14,587 warrants by acquiring 7,216 of shares of the Company's common stock through a cashless net share settlement. The Company recorded the issuance of the new Warrants using their estimated fair value on the date of issuance. The Company estimated the fair value of the new Warrants using the Black-Scholes option valuation model with the following assumptions: expected term of 5 years, a risk-free interest rate of 1.54%, expected volatility of 90% and 0% expected dividend yield. The resulting $1.2 million from the issuance of the new Warrants was recorded as a charge to other expense in the fourth quarter of fiscal 2015.

(15) Software Development Costs

On September 3, 2015, the Company entered into a software development agreement with a major aerospace and defense company whereby the aerospace company would develop and license its simulation software to the Company. The simulation software (also called Open Loop Simulator or OLS technology) is currently the aerospace' company's intellectual property. The OLS technology generates threat simulations and enables various hardware to generate signals for performing threat analysis on systems under test. The Company intends to license the OLS software as a bundled or integrated solution with its Advanced Signal Generator system. The Company is obligated to pay the aerospace company software development costs for OLS of $820,556 as well as a fixed fee of $98,467 ($919,023 in the aggregate), which is payable in monthly installments as the work is performed by the aerospace company through August 2016. The OLS technology is a perpetual license agreement that may be terminated by the Company at any time as long as the Company provides a notice to the aerospace company and pays for the development costs incurred through the notice termination date. The Company is also obligated to pay royalties to the aerospace company on net sales of its Advanced Signal Generator product sold with the OLS software equal to seven percent of net sales price of each ASG system sold or $20,000, whichever is greater. The agreement also provides for minimum calendar years royalties of $100,000 beginning six months from the date of delivery of the software data package to the Company, such amounts would be prorated for the fractional calendar year. In the event aggregate royalties in any calendar year are less than $100,000, the aerospace company may terminate the license agreement by giving the Company 30 day advance written notice. Royalties are payable within 30 days following each calendar quarter. The Company expenses research and development costs as they are incurred. Development costs of computer software to be sold, leased, or otherwise marketed are subject to capitalization beginning when a product's technological feasibility has been established and ending when a product is available for general release to customers. Capitalized software costs for the quarter ended September 26, 2015 were immaterial. The company intends to amortize the costs of capitalized software to cost of sales once the product is released to its customers

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ITEM 2 - MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The forward-looking statements included in this report including, without limitation, statements containing the words "believes", "anticipates", "estimates", "expects", "intends" and words of similar import, which reflect management’s best judgment based on factors currently known, involve risks and uncertainties. Actual results could differ materially from those anticipated in these forward-looking statements as a result of a number of factors, including but not limited to those listed in Giga-tronics’ Annual Report on Form 10-K for the fiscal year ended March 28, 2015 Part I, under the heading “Risk Factors”, and Part II, under the heading “Management’s Discussion and Analysis of Financial Conditions and Results of Operations”.

Overview

Giga-tronics produces instruments, subsystems and sophisticated microwave components that have broad applications in both defense electronics and wireless telecommunications. The Company has two reporting segments: Giga-tronics Division and Microsource.

Giga-tronics Division produces a broad line of test and measurement equipment used in the development, test and maintenance of wireless communications products and systems, flight navigational equipment, electronic defense systems and automatic testing systems and designs, manufactures, and markets a line of switching devices that link together many specific purpose instruments that comprise automatic test systems. These products are used primarily in the design, production, repair and maintenance of commercial telecommunications, radar, and electronic warfare equipment. Microsource develops and manufactures a broad line of YIG (Yttrium, Iron, Garnet) tuned oscillators, filters and microwave synthesizers, which are used by its customers in operational applications and in manufacturing a wide variety of microwave instruments and devices.

The Giga-tronics Division received orders of $1.5 million and $2.4 million in the first quarter of fiscal 2016 and 2015, respectively, from the United States Navy (“Navy”) for its Model 8003 Precision Scalar Analyzers and associated accessories (“8003”). In the first half of fiscal 2016 and fiscal 2015 the Navy was a significant customer for the Giga-tronics Division. The Company started shipping portions of the $1.5 million order in the first quarter of fiscal 2016, and completed the remaining portion in the second quarter of fiscal 2016. The Company shipped all of the $2.4 million order in the first half of fiscal 2015.

In the first quarter of fiscal 2016, the Company’s Microsource division received a $3.0 million order (“Ongoing Production Order”) for its high performance YIG filters from a major aerospace company extending its ongoing production of the filters for the aerospace company. The Company started shipments for this order in the second

quarter of fiscal 2016, and expects to complete it in the fourth quarter of fiscal 2016.

In the first quarter of fiscal 2015 the Microsource business unit received a $6.2 million order (“NRE Order”) for non-recurring engineering and for delivery of a limited number of flight-qualified prototype hardware from a major aerospace company to develop a variant of its high performance fast tuning YIG filters for an aircraft platform. In the first quarter of fiscal 2016 the Microsource business unit also finalized an associated multiyear $10.0 million YIG production order (“YIG Production Order”). The Company expects to start shipping the YIG Production Order in the fall of 2016.

In the second quarter and first half of fiscal 2016 and 2015 almost all of the orders and sales for the Microsource business unit were from two large aerospace customers. Almost all of the orders and revenue for the Microsource business is associated with programs for retrofitting radar filter components on existing military aircraft, and radar filter components for military aircraft being manufactured. The timing of orders and milestone achievements associated with these customers causes significant differences in orders, sales, deferred revenue, inventory and cash flow when comparing one fiscal period to another.

The Microsource NRE Order received in the first quarter of fiscal 2015 resulted in significant improvements to sales and results from operations when compared the first quarter of fiscal 2014. With a majority of the associated services from the NRE Order being completed in fiscal 2015 we do not expect to experience continued comparable increases in sales from fiscal 2015 to fiscal 2016, as we experienced from fiscal 2014 to fiscal 2015.

Results of Operations

New orders received by segment are as follows:

NEW ORDERS

(Dollars in thousands)	Three Month Periods Ended September 26, 2015	September 27, 2014	% change
Giga-tronics Division	$781	$ 1,223	(36)%
Microsource	61	114	(46)%
Total	$842	$ 1,337	(37)%

(Dollars in thousands)	Six Month Periods Ended September 26, 2015	September 27, 2014	% change
Giga-tronics Division	$4,289	$ 4,553	(6)%
Microsource	13,173	6,575	100 %
Total	$17,462	$ 11,128	57 %

New orders received in the second quarter of fiscal 2016 decreased by 37% to $842,000 from the $1.3 million received in the second quarter of fiscal 2015. New orders for the Giga-tronics Division saw a $276,000 decrease associated with legacy Power Meter products due to less demand for the product line, and a $102,000 decrease associated with Switching products due to timing of orders placed by customers over the fiscal year. New orders for the Microsource Division decreased due to the timing of large Microsource orders for radar filter components from two aerospace companies.

New orders received in the first half of fiscal 2016 increased 57% to $17.5 million from the $11.1 million received in the first half of fiscal 2015. The Microsource business unit saw a 100% increase in the first half of fiscal 2016 due to the receipt of the $10.0 million YIG Production Order and the $3.0 million Ongoing Production Order, compared to the $6.2 million NRE Order received in the first half of fiscal 2015. The decrease in the Giga-tronics Division was primarily due to the timing of orders as described in the paragraph above.

The following table shows order backlog and related information at the end of the respective periods:

BACKLOG

(Dollars in thousands)	**September 26, 2015**	**September 27, 2014**	**% change**	
Backlog of unfilled orders at end of period:				
Giga-tronics Division	$ 2,344	$ 2,235	5	%
Microsource	13,409	5,945	126	%
Total	$ 15,753	$ 8,180	93	%
Backlog of unfilled orders shippable within one year:				
Giga-tronics Division	$ 2,344	$ 2,235	5	