AEHR TEST SYSTEMS
Form 10-Q
October 12, 2018

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 August 31, 2018

OR

/ / TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission file number: 000-22893

AEHR TEST SYSTEMS
(Exact name of Registrant as specified in its charter)

California (State or other jurisdiction of incorporation or organization)	94-2424084 (I.R.S. Employer Identification No.)
400 Kato Terrace Fremont, CA (Address of principal executive offices)	94539 (Zip Code)

(510) 623-9400
(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 as the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files).

Yes No

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

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company
Emerging growth company	

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Yes No

Number of shares of the registrant’s common stock, $0.01 par value, outstanding as of September 28, 2018 was 22,253,698.

AEHR TEST SYSTEMS

FORM 10-Q

FOR THE QUARTER ENDED AUGUST 31, 2018

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PART I. FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS (Unaudited)

AEHR TEST SYSTEMS
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except per share data)
(unaudited)

	August 31, 2018	May 31, 2018 (1)
ASSETS		
Current assets:		
Cash and cash equivalents	$15,864	$16,848
Accounts receivable, net	2,272	2,856
Inventories	9,585	9,049
Prepaid expenses and other current assets	727	703
Total current assets	28,448	29,456
Property and equipment, net	1,174	1,203
Other assets	266	296
Total assets	$29,888	$30,955
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$1,317	$1,762
Accrued expenses	1,498	1,646
Customer deposits and deferred revenue, short-term	2,339	1,630
Current portion of long-term debt	6,110	6,110
Total current liabilities	11,264	11,148
Deferred rent	145	63
Deferred revenue, long-term	359	459
Total liabilities	11,768	11,670
Aehr Test Systems shareholders' equity:		
	222	221

Common stock, $0.01 par value: Authorized: 75,000; Issued and outstanding: 22,245 shares and 22,143 shares at August 31, 2018 and May 31, 2018, respectively		
Additional paid-in capital	83,405	83,041
Accumulated other comprehensive income	2,276	2,292
Accumulated deficit	(67,764)	(66,249)
Total Aehr Test Systems shareholders' equity	18,139	19,305
Noncontrolling interest	(19)	(20)
Total shareholders' equity	18,120	19,285
Total liabilities and shareholders' equity	$29,888	$30,955

(1)
The condensed consolidated balance sheet at May 31, 2018 has been derived from the audited consolidated financial statements at that date.

The accompanying notes are an integral part of these condensed consolidated financial statements.

AEHR TEST SYSTEMS
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

	Three Months Ended August 31,	
	2018	2017
Net sales	$4,740	$6,970
Cost of sales	3,187	4,052
Gross profit	1,553	2,918
Operating expenses:		
Selling, general and administrative	1,879	1,791
Research and development	1,116	955
Total operating expenses	2,995	2,746
(Loss) income from operations	(1,442)	172
Interest expense, net	(78)	(107)
Other income (expense), net	9	(60)
(Loss) income before income tax (expense) benefit	(1,511)	5
Income tax (expense) benefit	(4)	5
Net (loss) income	(1,515)	10
Less: Net income attributable to the noncontrolling interest	--	--
Net (loss) income attributable to Aehr Test Systems common shareholders	$(1,515)	$10
Net (loss) income per share		
Basic	$(0.07)	$0.00
Diluted	$(0.07)	$0.00
Shares used in per share calculations:		

Basic	22,190	21,417
Diluted	22,190	22,991

The accompanying notes are an integral part of these condensed consolidated financial statements.

AEHR TEST SYSTEMS
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME
(in thousands, unaudited)

	Three Months Ended August 31,	
	2018	2017
Net (loss) income	$(1,515)	$10
Other comprehensive (loss) income, net of tax:		
Net change in cumulative translation adjustments	(15)	59
Total comprehensive (loss) income	(1,530)	69
Less: Comprehensive income attributable to the noncontrolling interest	1	--
Comprehensive (loss) income, attributable to Aehr Test Systems common shareholders	$(1,531)	$69

The accompanying notes are an integral part of these
condensed consolidated financial statements.

AEHR TEST SYSTEMS
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Three Months Ended August 31,	
	2018	2017
Cash flows from operating activities:		
Net (loss) income	$(1,515)	$10
Adjustments to reconcile net (loss) income to net cash used in operating activities:		
Stock-based compensation expense	256	216
Provision for doubtful accounts	--	31
Depreciation and amortization	111	89
Changes in operating assets and liabilities:		
Accounts receivable	563	(1,260)
Inventories	(536)	(2,044)
Prepaid expenses and other current assets	4	(1,089)
Accounts payable	(398)	651
Accrued expenses	(151)	(21)
Customer deposits and deferred revenue	609	(440)
Deferred rent	82	--
Income taxes payable	4	(20)
Net cash used in operating activities	(971)	(3,877)
Cash flows from investing activities:		
Purchases of property and equipment	(84)	(184)
Net cash used in investing activities	(84)	(184)
Cash flows from financing activities:		
Proceeds from issuance of common stock under employee plans, net of taxes paid related to share settlement of equity awards	109	234
Net cash provided by financing activities	109	234
Effect of exchange rates on cash and cash equivalents	(38)	17
Net decrease in cash and cash equivalents	(984)	(3,810)
Cash and cash equivalents, beginning of period	16,848	17,803

Cash and cash equivalents, end of period	$15,864	$13,993
Supplemental disclosure of non-cash flow information:		
Transfers of property and equipment to inventories	$--	$372

The accompanying notes are an integral part of these condensed consolidated financial statements.

AEHR TEST SYSTEMS
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCCOUNTING POLICIES

The accompanying financial information has been prepared by Aehr Test Systems, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission, or SEC. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States (GAAP) have been condensed or omitted pursuant to such rules and regulations.

In the opinion of management, the unaudited condensed consolidated financial statements for the interim periods presented have been prepared on a basis consistent with the May 31, 2018 audited consolidated financial statements and reflect all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of the condensed consolidated financial position and results of operations as of and for such periods indicated. These unaudited condensed consolidated financial statements and notes thereto should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended May 31, 2018. Results for the interim periods presented herein are not necessarily indicative of results which may be reported for any other interim period or for the entire fiscal year.

PRINCIPLES OF CONSOLIDATION. The condensed consolidated financial statements include the accounts of Aehr Test Systems and its subsidiaries (collectively, the "Company"). All significant intercompany balances have been eliminated in consolidation. For the Company’s majority owned subsidiary, Aehr Test Systems Japan K.K., the noncontrolling interest of the portion the Company does not own was reflected on the Condensed Consolidated Balance Sheets in Shareholders’ Equity and in the Condensed Consolidated Statements of Operations.

ACCOUNTING ESTIMATES. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Estimates are used to account for sales and revenue allowances, the allowance for doubtful accounts, inventory valuations, income taxes, stock-based compensation expenses, and product warranties, among others. The Company bases its estimates on historical experience and on various other assumptions that it believes to be reasonable under the circumstances. Actual results could differ materially from those estimates.

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES. The Company’s significant accounting policies are disclosed in the Company’s Annual Report on Form 10-K for the year ended May 31, 2018. There have been no significant changes in our significant accounting policies during the three months ended August 31, 2018 except for revenue recognition.

REVENUE RECOGNITION. Revenue consists primarily of the sale of the following products and services: systems, WaferPaks, DiePaks, upgrade services, spare parts, application support, service contracts and extended warranty contracts. Revenue is recognized upon transferring control of products and performing services, and the amounts recognized reflect the consideration we expect to be entitled to receive in exchange for these products and services. We sell our products and services directly to customers and through distributors.

A performance obligation is a promise in a contract to transfer a distinct good or service to the customer. In contracts with multiple performance obligations, we identify each performance obligation and evaluate whether the performance obligation is distinct within the context of the contract at contract inception. A good or service that is not

distinct is combined with other promised goods or services until the Company identifies a bundle of goods or services that is distinct.

Our products may be customized to our customers' specifications, however, control of our product is typically transferred to the customer at the point in time the product is either shipped or delivered, depending on the terms of the arrangement, as the criteria for over time recognition is not met. In limited circumstances, substantive acceptance by the customer exists which results in the deferral of revenue until acceptance is formally received from the customer. Judgment may be required in determining if the acceptance clause is substantive.

Upgrade services are a distinct performance obligation apart from the systems and recognized in the period they are performed. Service contracts, which include repair and maintenance service contracts and extended warranty contracts, are also distinct performance obligations and recognized as our performance obligations are satisfied. This is typically the contractual service period, which ranges from one to three years. For these service contracts recognized over time, we use an input measure, days elapsed, to measure progress.

A contract's transaction price is allocated to each distinct performance obligation and recognized as revenue when, or as, the performance obligation is satisfied. In determining the transaction price, we evaluate whether the price is subject to refund or adjustment to determine the net consideration to which we expect to be entitled. We generally do not grant return privileges, except for defective products during the warranty period. Sales discounts that we may make available to these customers are considered to be a form of variable consideration, which is estimated in determining the contract's transaction price to be allocated to the performance obligations. We have elected the practical expedient under Accounting Standards Codification ("ASC") 606-10-32-18 to not assess whether a contract has a significant financing component as our standard payment terms are less than one year.

For contracts with multiple performance obligations, we allocate the contract's transaction price to each performance obligation based on its relative standalone selling price. The stand-alone selling prices are determined based on the prices at which we separately sell these products. For items that are not sold separately, we estimate the stand-alone selling prices using our best estimate of selling price.

Transaction price allocated to the remaining performance obligations. On August 31, 2018, we had $685,000 of remaining performance obligations, which were comprised of deferred service contracts and extended warranty contracts not yet delivered. We expect to recognize approximately 34% of our remaining performance obligations as revenue in fiscal 2019, and an additional 66% in fiscal 2020 and thereafter. The foregoing excludes the value of other remaining performance obligations as they have original durations of one year or less, and also excludes information about variable consideration allocated entirely to a wholly unsatisfied performance obligation.

Contract Assets and Liabilities. The timing of revenue recognition may differ from the timing of invoicing to customers. Accounts receivable is recorded at the invoiced amount, net of an allowance for doubtful accounts. A receivable is recognized in the period we deliver goods or provide services or when our right to consideration is unconditional. The Company usually does not record contract assets because the Company has an unconditional right to payment upon satisfaction of the performance obligation, and therefore, a receivable is more commonly recorded than a contract asset.

Contract liabilities include payments received in advance of performance under a contract and are satisfied as the associated revenue is recognized. Contract liabilities are reported on the Condensed Consolidated Balance Sheets at the end of each reporting period as a component of deferred revenue. Contract liabilities as of August 31, 2018 and May 31, 2018 were $2,698,000 and $2,089,000, respectively. During the three months ended August 31, 2018, we recognized $602,000 of revenues that was included in contract liabilities as of May 31, 2018.

Costs to obtain or fulfill a contract. The Company generally expenses sales commissions when incurred as a component of Selling, general and administrative expense as the amortization period is typically less than one year. Additionally, the majority of the Company's cost of fulfillment as a manufacturer of products is classified as inventory and fixed assets, which are accounted for under the respective guidance for those asset types. Other costs of contract fulfillment are immaterial due to the nature of our products and their respective manufacturing process.

Amount collected from customers. Sales tax collected from customers is not included in net sales but rather recorded as a liability due to the respective taxing authorities.

RECENT ACCOUNTING PRONOUNCEMENTS

Accounting Standards Adopted

Revenue Recognition

In May 2014, the FASB issued ASC Update No. 2014-09, Revenue from Contracts with Customers (Topic 606), which has been subsequently updated. The core principle of the standard is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration that is expected to be received for those goods or services. The new standard defines a five-step process to achieve this core principle and, in doing so, it is possible more judgment and estimates may be required within the revenue recognition process than required under existing GAAP, including identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price, and allocating the transaction price to each distinct performance obligation. The standard permits the use of either the retrospective or modified retrospective transition methods. It also requires expanded disclosures including the nature, amount, timing, and uncertainty of revenues and cash flows related to contracts with customers. Additionally, qualitative and quantitative disclosures are required about customer contracts, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract.

We adopted Accounting Standards Codification ("ASC") 606, Revenue from Contracts with Customers and all related amendments (collectively "ASC 606"), on June 1, 2018, the first day of fiscal 2019, using the modified retrospective method. We applied ASC 606 to all contracts not completed as of the date of adoption in order to determine any adjustment to the opening balance of retained earnings. Under the modified retrospective adoption method, the comparative financial information has not been restated and continues to be reported under the accounting standards in effect for those periods, ASC 605, "Revenue Recognition", which is also referred to herein as "legacy GAAP."

The adoption of ASC 606 did not have a material impact on our consolidated financial statements as of June 1, 2018. No adjustment was recorded to accumulated deficit as of the adoption date and reported revenue would not have been different under legacy GAAP. Additionally, we do not expect the adoption of the revenue standard to have a material impact to our net income on an ongoing basis.

Classification of Certain Cash Receipts and Cash Payments

In August 2016, the FASB issued authoritative guidance related to the classification of certain cash receipts and cash payments on the statement of cash flows. The Company adopted this new standard in fiscal year 2019. The adoption of this guidance did not have a significant impact on the Company's consolidated financial statements.

Intra-Entity Asset Transfers

In October 2016, the FASB issued an accounting standard update that requires recognition of the income tax consequences of intra-entity transfers of assets (other than inventory) at the transaction date. The Company adopted this new standard in fiscal year 2019. The adoption of this guidance did not have a significant impact on the Company's consolidated financial statements.

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Restricted Cash

In November 2016, the FASB issued authoritative guidance related to statements of cash flows. This guidance clarifies that amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of period total amounts shown on the statement of cash flows. The Company adopted this new standard in fiscal year 2019. The adoption of this guidance did not have a significant impact on the Company's consolidated financial statements.

Income Taxes

On December 22, 2017, the US government enacted comprehensive tax legislation commonly referred to as the Tax Cuts and Jobs Act (the "Tax Act"). The Tax Act makes broad and complex changes to the US tax code including but not limited to (1) reducing the US federal corporate tax rate from 34% to 21%; (2) requiring companies to pay a one-time transition tax on certain repatriated earnings of foreign subsidiaries; (3) generally eliminating US federal income taxes on dividends from foreign subsidiaries; (4) requiring a current inclusion in US federal income of certain earnings of controlled foreign corporations; (5) creating a new limitation on deductible interest expense; (6) changing rules related to the uses and limitations of net operating loss carryforwards created in tax years beginning after December 31, 2017, and (7) repeals the corporate alternative minimum tax regime, or AMT, effective December 31, 2017 and permits existing minimum tax credits to offset the regular tax liability for any tax year. Consequently, we have accounted for the reduction of $6.4 million of deferred tax assets with an offsetting adjustment to the valuation allowance for the fiscal year ended 2018, and recorded a benefit of $90,000 for our Federal refundable AMT credit.

On December 22, 2017, the SEC staff issued Staff Accounting Bulletin No. 118 ("SAB 118") which provides guidance on accounting for the tax effects of the Tax act. SAB 118 provides a measurement period that should not extend beyond one year from the Tax Act enactment date for companies to complete the accounting under ASC 740, Income taxes. In accordance with SAB 118, a company must reflect the income tax effects of those aspects of the Tax Act for which the accounting under ASC 740 is complete. To the extent that a company's accounting for certain income tax effects of the Tax Act is incomplete but it is able to determine a reasonable estimate, it must record a provisional estimate in the financial statements. There are also certain transitional impacts of the Tax Act. As part of the transition to the new territorial tax system, the Tax Act imposes a one-time repatriation tax on deemed repatriation of historical earnings of foreign subsidiaries. These transitional impacts have no impact to the company for the year fiscal year ended 2018. The one-time transition tax is based on post-1986 earnings and profits that were previously deferred from US income tax. While we have not yet finalized our calculation of the total post-1986 earnings and profits, for our foreign corporations or the impact of foreign tax credits, we have prepared a reasonable estimate and calculated the provision amount. The Company is evaluating the calculation of the transition tax. The accounting for this item is incomplete and may change as our interpretation of the provisions of the Act evolve, additional information becomes available or interpretive guidance is issued by the U.S. Treasury. The final determination will be completed no later than one year from the enactment date. Based on the current year and carryover losses and the valuation allowance the Company would not expect an impact to the financial statements as a result of the completion of the analysis.

Accounting Standards Not Yet Adopted

Financial Instruments

In January 2016, the FASB issued an accounting standard update related to recognition and measurement of financial assets and financial liabilities. This standard changes accounting for equity investments, financial liabilities under the fair value option and the presentation and disclosure requirements for financial instruments. In addition, it clarifies guidance related to the valuation allowance assessment when recognizing deferred tax assets resulting from unrealized losses on available-for-sale debt securities. This standard is effective for us in fiscal year 2020. Early adoption is permitted. The Company is currently evaluating the impact of this new guidance on its consolidated financial statements.

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In June 2016, the FASB issued an accounting standard update that requires measurement and recognition of expected credit losses for financial assets held based on historical experience, current conditions, and reasonable and supportable forecasts that affect the collectibility of the reported amount. The accounting standard update will be effective for the Company beginning in the first quarter of fiscal 2021 on a modified retrospective basis, and early adoption in fiscal 2020 is permitted. The Company is currently evaluating the impact of this accounting standard update on its consolidated financial statements.

Leases

In February 2016, the FASB issued authoritative guidance related to leases. This guidance requires management to present all leases greater than one year on the balance sheet as a liability to make payments and an asset as the right to use the underlying asset for the lease term. This new standard will be effective for us in fiscal year 2020, with early adoption permitted. The Company is currently evaluating the impact of adopting this new guidance on its consolidated financial statements.

2. EARNINGS PER SHARE

Basic earnings per share is determined using the weighted average number of common shares outstanding during the period. Diluted earnings per share is determined using the weighted average number of common shares and potential common shares (representing the dilutive effect of stock options, RSUs and ESPP shares) outstanding during the period using the treasury stock method.

The following table presents the computation of basic and diluted net (loss) income per share attributable to Aehr Test Systems common shareholders (in thousands, except per share data):

	Three Months Ended August 31,	
	2018	2017
Numerator: Net (loss) income	$(1,515)	$10
Denominator for basic net (loss) income per share:		
Weighted average shares outstanding	22,190	21,417
Shares used in basic net (loss) income per share calculation	22,190	21,417
Effect of dilutive securities	--	1,574
Denominator for diluted net (loss) income per share	22,190	22,991
Basic net (loss) income per share	$(0.07)	$0.00
Diluted net (loss) income per share	$(0.07)	$0.00

For the purpose of computing diluted earnings per share, the weighted average number of potential common shares does not include stock options with an exercise price greater than the average fair value of the Company's common stock for the period, as the effect would be anti-dilutive. In the three months ended August 31, 2018, potential common shares have not been included in the calculation of diluted net loss per share as the effect would be anti-dilutive. As such, the numerator and the denominator used in computing both basic and diluted net loss per share for this period are the same. Stock options to purchase 3,189,000 shares of common stock, RSUs for 43,000 shares and ESPP rights to purchase 359,000 ESPP shares were outstanding as of August 31, 2018 but were not included in the computation of diluted net loss per share, because the inclusion of such shares would be anti-dilutive. Stock options to purchase 140,000 shares of common stock were outstanding as of August 31, 2017, but were not included in the computation of diluted net income per share, because the inclusion of such shares would be anti-dilutive. The 2,657,000 shares convertible under the convertible notes outstanding on August 31, 2018 and 2017 were not included in the computation of diluted net (loss) income per share, because the inclusion of such shares would be anti-dilutive.

3. CASH, CASH EQUIVALENTS AND INVESTMENTS

The following table summarizes the Company's cash, cash equivalents and investments by security type at August 31, 2018 (in thousands):

	Cost	Gross Unrealized Loss	Estimated Fair Value
Cash	$2,587	$--	$2,587
Cash equivalents:			
Money market funds	13,277	--	13,277
U.S. Treasury securities	--	--	--
Total Cash equivalents	13,277	--	13,277
Total Cash and Cash equivalents	$15,864	$--	$15,864
Long-term investments:			
Certificate of deposit	$80	$--	$80
Total Cash, Cash equivalents and Investments	$15,944	$--	$15,944

Long-term investments are included in other assets on the accompanying condensed consolidated balance sheet at August 31, 2018.

The following table summarizes the Company's cash, cash equivalents and investments by security type at May 31, 2018 (in thousands):

	Cost	Gross Unrealized Loss	Estimated Fair Value
Cash	$3,132	$--	$3,132
Cash equivalents:			
Money market funds	7,733	--	7,733
U.S. Treasury securities	5,983	--	5,983
Total Cash equivalents	13,716	--	13,716
Total Cash and Cash equivalents	$16,848	$--	$16,848
Long-term investments:			
Certificate of deposit	$80	$--	$80
Total Cash, Cash equivalents and Investments	$16,928	$--	$16,928

Long-term investments are included in other assets on the accompanying consolidated balance sheet at May 31. 2018.

Unrealized gains and temporary losses on investments classified as available-for-sale are included within accumulated other comprehensive income ("AOCI"), net of any related tax effect. Upon realization, those amounts are reclassified from AOCI to results of operations.

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4. FAIR VALUE OF FINANCIAL INSTRUMENTS

The Company's financial instruments are measured at fair value consistent with authoritative guidance. This authoritative guidance defines fair value, establishes a framework for using fair value to measure assets and liabilities, and disclosures required related to fair value measurements.

The guidance establishes a fair value hierarchy based on inputs to valuation techniques that are used to measure fair value that are either observable or unobservable. Observable inputs reflect assumptions market participants would use in pricing an asset or liability based on market data obtained from independent sources while unobservable inputs reflect a reporting entity's pricing based upon their own market assumptions. The fair value hierarchy consists of the following three levels:

Level 1 - instrument valuations are obtained from real-time quotes for transactions in active exchange markets involving identical assets.

Level 2 - instrument valuations are obtained from readily-available pricing sources for comparable instruments.

Level 3 - instrument valuations are obtained without observable market values and require a high level of judgment to determine the fair value.

The following table summarizes the Company's financial assets measured at fair value on a recurring basis as of August 31, 2018 (in thousands):

	Balance as of August 31, 2018	Level 1	Level 2	Level 3
Money market funds	$13,277	$13,277	$--	$--
Certificate of deposit	80	--	80	--
Assets	$13,357	$13,277	$80	$--

The following table summarizes the Company's financial assets measured at fair value on a recurring basis as of May 31, 2018 (in thousands):

	Balance as of May 31, 2018	Level 1	Level 2	Level 3
Money market funds	$7,733	$7,733	$--	$--
U.S. Treasury securities	5,983	5,983	--	--
Certificate of deposit	80	--	80	--
Assets	$13,796	$13,716	$80	$--

The U.S. Treasury Securities have maturities of three months.

There were no financial liabilities measured at fair value as of August 31, 2018 and May 31, 2018.

There were no transfers between Level 1 and Level 2 fair value measurements during the three months ended August 31, 2018.

The carrying amounts of financial instruments including cash, cash equivalents, receivables, accounts payable and certain other accrued liabilities, approximate fair value due to their short maturities. Based on the borrowing rates currently available to the Company for loans with similar terms, the carrying value of the debt approximates the fair value.

The Company has, at times, invested in debt and equity of private companies, and may do so again in the future, as part of its business strategy.

5. ACCOUNTS RECEIVABLE, NET

Accounts receivable represent customer trade receivables and is presented net of allowance for doubtful accounts of $0 at August 31, 2018 and $4,000 at May 31, 2018. Accounts receivable are derived from the sale of products throughout the world to semiconductor manufacturers, semiconductor contract assemblers, electronics manufacturers and burn-in and test service companies. The Company’s allowance for doubtful accounts is based upon historical experience and review of trade receivables by aging category to identify specific customers with known disputes or collection issues. Uncollectible receivables are recorded as bad debt expense when all efforts to collect have been exhausted and recoveries are recognized when they are received.

6. INVENTORIES

Inventories are comprised of the following (in thousands):

	August 31, 2018	May 31, 2018
Raw materials and sub-assemblies	$6,103	$5,747
Work in process	3,248	3,068
Finished goods	234	234
	$9,585	$9,049

7. PRODUCT WARRANTIES

The Company provides for the estimated cost of product warranties at the time revenues are recognized on the products shipped. While the Company engages in extensive product quality programs and processes, including actively monitoring and evaluating the quality of its component suppliers, the Company’s warranty obligation is affected by product failure rates, material usage and service delivery costs incurred in correcting a product failure. Should actual product failure rates, material usage or service delivery costs differ from the Company’s estimates, revisions to the estimated warranty liability would be required.

The standard warranty period is one year for systems and ninety days for parts and service.

The following is a summary of changes in the Company's liability for product warranties during the three months ended August 31, 2018 and 2017 (in thousands):

	Three Months Ended August 31,	
	2018	2017

Balance at the beginning of the period	$135	$113
Accruals for warranties issued during the period	75	94
Consumption of reserves	(50)	(88)
Balance at the end of the period	$160	$119

The accrued warranty balance is included in accrued expenses on the accompanying condensed consolidated balance sheets.

8. CUSTOMER DEPOSITS AND DEFERRED REVENUE, SHORT-TERM

Customer deposits and deferred revenue, short-term (in thousands):

	August 31, 2018	May 31, 2018
Customer deposits	$2,014	$1,340
Deferred revenue	325	290
	$2,339	$1,630

9. INCOME TAXES

Income taxes have been provided using the liability method whereby deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and net operating loss and tax credit carryforwards measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse or the carryforwards are utilized. Valuation allowances are established when it is determined that it is more likely than not that such assets will not be realized.

Since fiscal 2009, a full valuation allowance was established against all deferred tax assets as management determined that it is more likely than not that certain deferred tax assets will not be realized.

The Company accounts for uncertain tax positions consistent with authoritative guidance. The guidance prescribes a “more likely than not” recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Company does not expect any material change in its unrecognized tax benefits over the next twelve months. The Company recognizes interest and penalties related to unrecognized tax benefits as a component of income taxes.

On December 22, 2017, the U.S. government enacted comprehensive tax legislation commonly referred to as the Tax Cuts and Jobs Act (the “Tax Act”). On December 22, 2017, the SEC staff issued Staff Accounting Bulletin No. 118 (“SAB 118”), which provides guidance on accounting for the tax effects of the Tax Act. SAB 118 provides a measurement period that should not extend beyond one year from the Tax Act enactment date for companies to complete the accounting under ASC 740, Income taxes. In accordance with SAB 118, a company must reflect the income tax effects of those aspects of the Tax Act for which the accounting under ASC 740 is complete. To the extent that a company’s accounting for certain income tax effects of the Tax Act is incomplete but it is able to determine a reasonable estimate, it must record a provisional estimate in the financial statements.

As part of the transition to the new territorial tax system, the Tax Act imposes a one-time repatriation tax on deemed repatriation of historical earnings of foreign subsidiaries. The company is not subject to the transition tax. The one-time transition tax is based on post-1986 earnings and profits that were previously deferred from U.S. income tax. While the Company has not yet finalized its calculation of the total post-1986 earnings and profits for its foreign corporations or the impact of foreign tax credits, it has prepared a reasonable estimate and calculation of nil transition tax. The Company is continuing to evaluate the calculation and accounting of the transition tax, which may change as the Company's interpretation of the provisions of the Tax Act evolve, additional information becomes available or interpretive guidance is issued by the U.S. Treasury. The final determination will be completed no later than one year from the enactment date. Based on current year and carryover losses and valuation allowance, the Company does not expect an impact to its consolidated financial statements upon completion of the analysis.

The new law effective December 31, 2017 repeals the corporate alternative minimum tax, or AMT, regime and permits existing minimum tax credits to offset the regular tax liability for any tax year. Further, the credit is

refundable for any tax year beginning after December 31, 2017 and before December 31, 2020 in an amount equal to 50% of the excess of the minimum tax credit over the allowable credit for the year against the regular tax liability. Any unused minimum tax credit carryforward is refundable in the following year. As result, the company recorded a benefit of $90,000 in the third quarter of fiscal 2018 for its Federal refundable AMT credit.

In addition, the reduction of the U.S. federal corporate tax rate reduces the corporate tax rate to 21%, effective January 1, 2018. Consequently, the Company has accounted for the reduction of $6.4 million of deferred tax assets with an offsetting adjustment to the valuation allowance.

Although the Company files U.S. federal, various state, and foreign tax returns, the Company's only major tax jurisdictions are the United States, California, Germany and Japan. Tax years 1996 – 2017 remain subject to examination by the appropriate governmental agencies due to tax loss carryovers, research and development tax credits, or other tax attributes from those years.

10. LONG-TERM DEBT

On April 10, 2015, the Company entered into a Convertible Note Purchase and Credit Facility Agreement (the "Purchase Agreement") with QVT Fund LP and Quintessence Fund L.P. (the "Purchasers") providing for (a) the Company's sale to the Purchasers of $4,110,000 in aggregate principal amount of 9.0% Convertible Secured Notes due 2017 (the "Convertible Notes") and (b) a secured revolving loan facility (the "Credit Facility") in an aggregate principal amount of up to $2,000,000. On August 22, 2016 the Purchase Agreement was amended to extend the maturity date of the Convertible Notes to April 10, 2019, decrease the conversion price from $2.65 per share to $2.30 per share, decrease the forced conversion price from $7.50 per share to $6.51 per share, and allow for additional equity awards.

The Convertible Notes bear interest at an annual rate of 9.0% and will mature on April 10, 2019 unless repurchased or converted prior to that date. Interest is payable quarterly on March 1, June 1, September 1 and December 1 of each year. Debt issuance costs of $356,000, which were accreted over the term of the original loan using the effective interest rate method, were offset against the loan balance.

The conversion price for the Convertible Notes is $2.30 per share and is subject to adjustment upon the occurrence of certain specified events. Holders may convert all or any part of the principal amount of their Convertible Notes in integrals of $10,000 at any time prior to the maturity date. Upon conversion, the Company will deliver shares of its common stock to the holder of Convertible Notes electing such conversion. The Company may not redeem the Convertible Notes prior to maturity.

The maximum amount of $2,000,000 drawn against the Credit Facility has been converted to Convertible Notes, and at August 31, 2018 there was no remaining balance available to be drawn on the Credit Facility.

The Company's obligations under the Purchase Agreement are secured by substantially all of the assets of the Company.

11. STOCKHOLDERS' EQUITY, COMPREHENSIVE INCOME AND STOCK-BASED COMPENSATION

ACCUMULATED OTHER COMPREHENSIVE INCOME

Changes in the components of AOCI, net of tax, were as follows (in thousands):

	Cumulative Translation Adjustments	Unrealized Loss on Investments, Net	Total
Balance at May 31, 2018	$2,292	$--	$2,292
Other comprehensive (loss) income before reclassifications	(16)	--	(16)
Amounts reclassified out of AOCI	--	--	--
Other comprehensive (loss) income, net of tax	(16)	--	(16)
Balance at August 31, 2018	$2,276	$--	$2,276

STOCK-BASED COMPENSATION

Stock-based compensation expense consists of expenses for stock options, restricted stock units, or RSUs, and employee stock purchase plan, or ESPP, purchase rights. Stock-based compensation expense for stock options and ESPP purchase rights is measured at each grant date, based on the fair value of the award using the Black-Scholes option valuation model, and is recognized as expense over the employee's requisite service period. This model was developed for use in estimating the value of publicly traded options that have no vesting restrictions and are fully transferable. The Company's employee stock options have characteristics significantly different from those of publicly traded options. For RSUs, stock-based compensation cost is based on the fair value of the Company's common stock at the grant date. All of the Company's stock-based compensation is accounted for as an equity instrument. See Note 10 in the Company's Annual Report on Form 10-K for fiscal 2018 filed on August 28, 2018 for further information regarding the 2016 Equity Incentive Plan and the Amended and Restated 2006 ESPP.

The following table summarizes the stock-based compensation expense for the three months ended August 31, 2018 and 2017 (in thousands):

	Three Months Ended August 31,	
	2018	2017
Stock-based compensation in the form of employee stock options, RSUs and ESPP purchase rights, included in:		
Cost of sales	$36	$22
Selling, general and administrative	148	150
Research and development	72	44
Net effect on net (loss) income	$256	$216

As of August 31, 2018 and 2017, there were no stock-based compensation expenses capitalized as part of inventory.

During the three months ended August 31, 2018 and 2017, the Company recorded stock-based compensation expenses related to stock options and RSUs of $173,000 and $201,000, respectively.

As of August 31, 2018, the total compensation expense related to unvested stock-based awards under the Company's 2016 Equity Incentive Plan, but not yet recognized, was approximately $1,449,000, which is net of estimated forfeitures of $4,000. This expense will be amortized on a straight-line basis over a weighted average period of approximately 3.2 years.

During the three months ended August 31, 2018 and 2017, the Company recorded stock-based compensation expense related to the ESPP of $83,000 and $15,000, respectively.

As of August 31, 2018, the total compensation expense related to purchase rights under the ESPP but not yet recognized was approximately $223,000. This expense will be amortized on a straight-line basis over a weighted average period of approximately 1.1 years.

Valuation Assumptions

Valuation and Amortization Method. The Company estimates the fair value of stock options granted using the Black-Scholes option valuation model and a single option award approach. The fair value under the single option approach is amortized on a straight-line basis over the requisite service periods of the awards, which is generally the vesting period.

Expected Term. The Company's expected term represents the period that the Company's stock-based awards are expected to be outstanding and was determined based on historical experience, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior as evidenced by changes to the terms of its stock-based awards.

Volatility. Volatility is a measure of the amounts by which a financial variable such as stock price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. The Company uses the historical volatility for the past four or five years, which matches the expected term of most of the option grants, to estimate expected volatility. Volatility for each of the ESPP's four time periods of six months, twelve months, eighteen months, and twenty-four months is calculated separately and included in the overall stock-based compensation expense recorded.

Risk-Free Interest Rate. The Company bases the risk-free interest rate used in the Black-Scholes option valuation model on the implied yield in effect at the time of option grant on U.S. Treasury zero-coupon issues with a remaining term equivalent to the expected term of the stock awards including the ESPP.

Fair Value. The fair value of the Company's stock options granted to employees for the three months ended August 31, 2018 and 2017 were estimated using the following weighted average assumptions in the Black-Scholes option valuation model:

	Three Months Ended August 31,	
	2018	2017
Expected term (in years)	5	4
Volatility	0.74	0.78
Risk-free interest rate	2.75%	1.75%
Weighted average grant date fair value	$1.48	$2.27

There were no ESPP purchase rights granted to employees for the three months ended August 31, 2018 and 2017. There were no ESPP shares issued during the three months ended August 31, 2018 and 2017. As of August 31, 2018, there were 145,000 ESPP shares available for issuance.

The following tables summarize the Company's stock option and RSU transactions during three months ended August 31, 2018 (in thousands):

	Available Shares
Balance, May 31, 2018	1,812
Options granted	(441)
RSUs granted	--
Shares cancelled	13
Shares expired	(11)
Balance, August 31, 2018	1,373

The following table summarizes the stock option transactions during the three months ended August 31, 2018 (in thousands, except per share data):

	Outstanding Options		
	Number of Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value
Balances, May 31, 2018	2,859	$2.04	$1,987
Options granted	441	$2.40	
Options cancelled	(13)	$1.64	
Options exercised	(98)	$1.12	
Balances, August 31, 2018	3,189	$2.12	$1,757
Options fully vested and expected to vest at August 31, 2018	3,156	$2.12	$1,746

The options outstanding and exercisable at August 31, 2018 were in the following exercise price ranges (in thousands, except per share data):

	Options Outstanding at August 31, 2018			Options Exercisable at August 31, 2018			
Range of Exercise Prices	Number Outstanding Shares	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable Shares	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Aggregate Intrinsic Value
$0.59-$0.97	259	0.51	$0.67	259	0.51	$0.67	
$1.09-$1.36	507	1.46	$1.28	506	1.46	$1.28	
$1.68-$2.06	466	4.04	$1.74	318	3.64	$1.77	
$2.10-$2.81	1,695	4.34	$2.44	1,130	3.26	$2.47	
$3.46-$3.93	262	5.91	$3.86	94	5.96	$3.76	
$0.59-$3.93	3,189	3.66	$2.12	2,307	2.72	$1.96	$1,541

The total intrinsic value of options exercised during the three months ended August 31, 2018 and 2017 was $139,000 and $476,000, respectively. The weighted average remaining contractual life of the options exercisable and expected to be exercisable at August 31, 2018 was 3.64 years.

During the three months ended August 31, 2018, there were no RSUs granted to employees. During the three months ended August 31, 2017, RSUs for 64,000 shares were granted to employees. The market value on the date of the grant of these RSUs was $3.93 per share. 2,000 RSUs became fully vested during the three months ended August 31, 2017, and 93,000 RSUs were unvested at August 31, 2017. During the three months ended August 31, 2018, 4,000 RSUs became fully vested. As of August 31, 2018, 43,000 RSUs remain unvested which have an intrinsic value of $108,000.

12. SEGMENT INFORMATION

The Company operates in one reportable segment: the design, manufacture and marketing of advanced test and burn-in products to the semiconductor manufacturing industry.

The following presents information about the Company’s operations in different geographic areas. Net sales are based upon ship-to location (in thousands).

	United States	Asia	Europe	Total
Three months ended August 31, 2018:				
Net sales	$2,695	$1,734	$311	$4,740
Property and equipment, net	1,130	39	5	1,174
Three months ended August 31, 2017:				
Net sales	$1,290	$5,660	$20	$6,970
Property and equipment, net	1,089	39	12	1,140

The following table shows revenues by major product categories, similar to our reportable segment disclosure. Within each product category, contract terms, conditions and economic factors affecting the nature, amount, timing and uncertainty around revenue recognition and cash flow are substantially similar. With the exception of the amount of service revenues, our product category revenues are recognized at point in time when control transfers to customers. Our revenues by product category are as follows (in thousands):

	Three Months Ended August 31,	
	2018	2017
Type of good / service:		
Systems	$1,806	$3,476
Contactors	1,153	2,677
Services	1,781	817
	$4,740	$6,970
Timing of revenue recognition:		
Products and services transferred at a point in time	$4,118	$6,500
Services transferred over time	622	470
	$4,740	$6,970

There were no revenues through distributors for the three months ended August 31, 2018 and 2017.

The Company’s Japanese and German subsidiaries primarily comprise the foreign operations. Substantially all of the sales of the subsidiaries are made to unaffiliated Japanese or European customers. Net sales from outside the United

States include those of Aehr Test Systems Japan K.K. and Aehr Test Systems GmbH.

Sales to the Company’s five largest customers accounted for approximately 78% and 99% of its net sales for the three months ended August 31, 2018 and 2017, respectively. Four customers accounted for approximately 21%, 18%, 17% and 14% of the Company’s net sales in the three months ended August 31, 2018. Two customers accounted for approximately 54% and 35% of the Company’s net sales in the three months ended August 31, 2017. No other customers represented more than 10% of the Company's net sales for either of the three months ended August 31, 2018 and 2017.

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

The following discussion of the financial condition and results of operations should be read in conjunction with the unaudited condensed consolidated financial statements and the related notes that appear elsewhere in this report and with our Annual Report on Form 10-K for the fiscal year ended May 31, 2018 and the consolidated financial statements and notes thereto.

In addition to historical information, this report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. All statements in this report, including those made by our management, other than statements of historical fact, are forward-looking statements. These statements typically may be identified by the use of forward-looking words or phrases such as "believe," "expect," "intend," "anticipate," "should," "planned," "estimated," and "potential," among others and include, but are not limited to, statements concerning our expectations regarding our operations, business, strategies, prospects, revenues, expenses, costs and resources. These forward-looking statements are subject to certain risks and uncertainties that could cause our actual results to differ materially from those anticipated results or other expectations reflected in the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in this report and other factors beyond our control, and in particular, the risks discussed in “Part II, Item 1A. Risk Factors” and those discussed in other documents we file with the SEC. All forward-looking statements included in this document are based on our current expectations, and we undertake no obligation to revise or publicly release the results of any revision to these forward-looking statements. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements.

OVERVIEW

We were founded in 1977 to develop and manufacture burn-in and test equipment for the semiconductor industry. Since our inception, we have sold more than 2,500 systems to semiconductor manufacturers, semiconductor contract assemblers and burn-in and test service companies worldwide. Our principal products currently are the Advanced Burn-in and Test System, or ABTS, the FOX full wafer contact parallel test and burn-in system, WaferPak contactors, the DiePak carrier and test fixtures.

Our net sales consist primarily of sales of systems, WaferPak contactors, DiePak Carriers, test fixtures, upgrades and spare parts, revenues from service contracts, and engineering development charges. Our selling arrangements may include contractual customer acceptance provisions, which are mostly deemed perfunctory or inconsequential, and installation of the product occurs after shipment and transfer of title.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis of our financial condition and results of operations are based upon our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these condensed consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to customer programs and incentives, product returns, bad debts, inventories, income taxes, financing operations, warranty obligations, and long-term service contracts. Our estimates are derived from historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Those results form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. For a discussion of the critical accounting policies, see “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies and Estimates” in our Annual Report on Form 10-K for the fiscal year ended May 31, 2018.

There have been no material changes to our critical accounting policies and estimates during the three months ended August 31, 2018 compared to those discussed in our Annual Report on Form 10-K for the fiscal year ended May 31, 2018.

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RESULTS OF OPERATIONS

The following table sets forth items in our unaudited condensed consolidated statements of operations as a percentage of net sales for the periods indicated.

	Three Months Ended August 31,	
	2018	2017
Net sales	100.0%	100.0%
Cost of sales	67.2	58.1
Gross profit	32.8	41.9
Operating expenses:		
Selling, general and administrative	39.6	25.7
Research and development	23.6	13.7
Total operating expenses	63.2	39.4
(Loss) income from operations	(30.4)	2.5
Interest expense, net	(1.7)	(1.5)
Other income (expense), net	0.2	(0.9)
(Loss) income before income tax (expense) benefit	(31.9)	0.1
Income tax (expense) benefit	(0.1)	--
Net (loss) income	(32.0)	0.1
Less: Net income attributable to the noncontrolling interest	--	--
Net (loss) income attributable to Aehr Test Systems common shareholders	(32.0)%	0.1%

THREE MONTHS ENDED AUGUST 31, 2018 COMPARED TO THREE MONTHS ENDED AUGUST 31, 2017

NET SALES. Net sales decreased to $4.7 million for the three months ended August 31, 2018 from $7.0 million for the three months ended August 31, 2017, a decrease of 32.0%. The decrease in net sales for the three months ended August 31, 2018 was primarily due to the decrease in net sales of our wafer-level products. Net sales of the wafer-level products for the three months ended August 31, 2018 were $2.0 million, and decreased approximately $2.2 million from the three months ended August 31, 2017.

GROSS PROFIT. Gross profit decreased to $1.6 million for the three months ended August 31, 2018 from $2.9 million for the three months ended August 31, 2017, a decrease of approximately 46.8%. Gross profit margin decreased to 32.8% for the three months ended August 31, 2018 from 41.9% for the three months ended August 31, 2017. The decrease in gross profit margin was primarily a result of manufacturing inefficiencies due to a lower level of net sales.

SELLING, GENERAL AND ADMINISTRATIVE. SG&A expenses increased to $1.9 million for the three months ended August 31, 2018 from $1.8 million for the three months ended August 31, 2017, an increase of 4.9%. The increase in SG&A expenses was primarily due to an increase in employment related expenses.

RESEARCH AND DEVELOPMENT. R&D expenses increased to $1.1 million for the three months ended August 31, 2018 from $1.0 million for the three months ended August 31, 2017, an increase of 16.9%. The increase in R&D expenses was primarily due to an increase in employment related expenses.

INTEREST EXPENSE, NET. Interest expense, net was $78,000 and $107,000 for the three months ended August 31, 2018 and 2017, respectively. The lower interest expense, net in the three months ended August 31, 2018 was primarily a result of higher interest income due to the increase in the interest rate as well as a higher average cash balance during the period compared with the three months ended August 31, 2017.

OTHER INCOME (EXPENSE), NET. Other income, net was $9,000 for the three months ended August 31, 2018 compared with other expense, net of $60,000 for the three months ended August 31, 2017. The change in other income (expense), net was primarily due to gains or losses realized in connection with the fluctuation in the value of the dollar compared to foreign currencies during the referenced periods.

INCOME TAX (EXPENSE) BENEFIT. Income tax expense was $4,000 for the three months ended August 31, 2018 compared with income tax benefit of $5,000 for the three months ended August 31, 2017.

LIQUIDITY AND CAPITAL RESOURCES

Net cash used in operating activities was $1.0 million and $3.9 million for the three months ended August 31, 2018 and 2017, respectively. For the three months ended August 31, 2018, net cash used in operating activities was primarily the result of the net loss of $1.5 million, as adjusted to exclude the effect of a non-cash charge of stock-based compensation expense of $0.3 million and depreciation and amortization of $0.1 million. Other changes in cash from operations primarily resulted from an increase in customer deposits and deferred revenue of $0.6 million and a decrease in accounts receivable of $0.6 million, partially offset by an increase in inventories of $0.5 million, and decreases in accounts payable of $0.4 million and accrued expenses of $0.2 million. The increase in customer deposits and deferred revenue was primarily due to the receipt of additional down payments from certain customers. The decrease in accounts receivable was primarily due to improvements in customer payment terms. The increase in inventories is to support future shipments for customer orders. The decrease in accounts payable was primarily due to lower expenditures associated with lower revenue. The decrease in accrued expenses was primarily due to the interest payment before the end of the quarter. For the three months ended August 31, 2017, net cash used in operating activities was primarily due to the increases in inventories of $2.0 million, accounts receivable of $1.3 million, and prepaid expenses and other current assets of $1.1 million, partially offset by an increase in accounts payable of $0.7 million. The increase in inventories is to support future shipments for customer orders. The increase in accounts receivable was primarily due to an increase in sales. The increase in prepaid expenses and other current assets was primarily due to down payments to certain vendors. The increase in accounts payable was primarily due to higher expenditures associated with higher revenue.

Net cash used in investing activities was $84,000 and $184,000 for the three months ended August 31, 2018 and 2017, respectively. Net cash used in investing activities during the three months ended August 31, 2018 and 2017 was due to purchases of property and equipment.

Net cash provided by financing activities was $109,000 and $234,000 for the three months ended August 31, 2018 and 2017, respectively. Net cash provided by financing activities during the three months ended August 31, 2018 and 2017 was due to proceeds from the issuance of common stock under employee plans.

The effect of fluctuation in exchange rates decreased cash by $38,000 for the three months ended August 31, 2018 and increased cash by $17,000 for the three months ended August 31, 2017. The changes were due to the fluctuation in the value of the dollar compared to foreign currencies.

As of August 31, 2018 and May 31, 2018, we had working capital of $17.2 million and $18.3 million, respectively.

We lease our manufacturing and office space under operating leases. We entered into a non-cancelable operating lease agreement for our United States manufacturing and office facilities, which was renewed in February 2018 and expires in July 2023. Under the lease agreement, we are responsible for payments of utilities, taxes and insurance.

From time to time, we evaluate potential acquisitions of businesses, products or technologies that complement our business. If consummated, any such transactions may use a portion of our working capital or require the issuance of equity. We have no present understandings, commitments or agreements with respect to any material acquisitions.

We anticipate that the existing cash balance together with income from operations, collections of existing accounts receivable, revenue from our existing backlog of products, the sale of inventory on hand, and deposits and down payments against significant orders will be adequate to meet our liquidity requirements for the next 12 months.

OFF-BALANCE SHEET ARRANGEMENTS

We have not entered into any off-balance sheet financing arrangements and have not established any variable interest entities.

OVERVIEW OF CONTRACTUAL OBLIGATIONS

There have been no material changes in the composition, magnitude or other key characteristics of our contractual obligations or other commitments as disclosed in the Company's Annual Report on Form 10-K for the year ended May 31, 2018.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

We had no holdings of derivative financial or commodity instruments as of August 31, 2018 or May 31, 2018.

We are exposed to financial market risks, including changes in interest rates and foreign currency exchange rates. We only invest our short-term excess cash in government-backed securities with maturities of 18 months or less. We do not use any financial instruments for speculative or trading purposes. Fluctuations in interest rates would not have a material effect on our financial position, results of operations or cash flows.

A majority of our revenue and capital spending is transacted in U.S. Dollars. We, however, enter into transactions in other currencies, primarily Euros and Japanese Yen. Since the price is determined at the time a purchase order is accepted, we are exposed to the risks of fluctuations in the foreign currency-U.S. Dollar exchange rates during the lengthy period from purchase order to ultimate payment. This exchange rate risk is partially offset to the extent that our subsidiaries incur expenses payable in their local currency. To date, we have not invested in instruments designed to hedge currency risks. In addition, our subsidiaries typically carry debt or other obligations due to us that may be denominated in either their local currency or U.S. Dollars. Since our subsidiaries' financial statements are based in their local currency and our condensed consolidated financial statements are based in U.S. Dollars, we and our subsidiaries recognize foreign exchange gains or losses in any period in which the value of the local currency rises or falls in relation to the U.S. Dollar. A 10% decrease in the value of the subsidiaries' local currency as compared with the U.S. Dollar would not be expected to result in a significant change to our net income or loss. There have been no material changes in our risk exposure since the end of the last fiscal year, nor are any material changes to our risk exposure anticipated.

Item 4. CONTROLS AND PROCEDURES

EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES. Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities and Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms, and that such information is accumulated and communicated to management as appropriate to allow for timely decisions regarding required disclosure.

CHANGES IN INTERNAL CONTROLS OVER FINANCIAL REPORTING. There was no change in our internal control over financial reporting, as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act, that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

INHERENT LIMITATIONS OF INTERNAL CONTROLS. Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls and procedures or our internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within us have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of a simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving our stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

PART II - OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

None.

Item 1A. RISK FACTORS

Please refer to the description of the risk factors associated with our business previously disclosed in Part I, Item 1A - "Risk Factors" of our Annual Report on Form 10-K for the year ended May 31, 2018 filed with the Securities and Exchange Commission on August 28, 2018.

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

Exhibit No.	Description
31.1	Certification of Chief Executive Officer pursuant to Rules 13a-14(a) and 15d-14(a) promulgated under the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Rules 13a-14(a) and 15d-14(a) promulgated under the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.*
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

*This exhibit shall not be deemed “filed” for purposes of Section 18 of the Securities Exchange Act of 1934 or otherwise subject to the liabilities of that Section, nor shall it be deemed incorporated by reference in any filings under the Securities Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date hereof and irrespective of any general incorporation language in any filings.

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SIGNATURES

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

Aehr Test Systems
Registrant)

Date: October 12, 2018 By: /s/ GAYN ERICKSON
Gayn Erickson
President and Chief Executive Officer

Date: October 12, 2018 By: /s/ KENNETH B. SPINK
Kenneth B. Spink
Vice President of Finance and Chief Financial Officer