21ST CENTURY HOLDING CO
Form 10-Q
May 12, 2006

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 MARCH 31, 2006

OR

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

FOR THE TRANSITION PERIOD FROM __________________ TO ______________________.

Commission file number 0-2500111

21st Century Holding Company
(Exact name of registrant as specified in its charter)

Florida	**65-0248866**
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification No.)

3661 West Oakland Park Boulevard, Suite 300, Lauderdale Lakes, Florida 33311
(Address of principal executive offices) (Zip Code)

954-581-9993
(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 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 o

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

Large accelerated filer o   Accelerated filer x   Non-accelerated filer o

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

Yes o No x

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common Stock, $.01 par value - 7,420,819 outstanding as of May 10, 2006.

21ST CENTURY HOLDING COMPANY

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PART I: FINANCIAL INFORMATION
Item 1

21ST CENTURY HOLDING COMPANY
CONSOLIDATED BALANCE SHEETS

	March 31, 2006	December 31, 2005
ASSETS		
Investments		
Fixed maturities, available for sale, at fair value	$ 79,345,703	$ 69,787,809
Fixed maturities, held to maturity, at amoritized cost	19,685,847	19,691,937
Equity securities, available for sale, at fair value	8,578,837	10,606,663
Total investments	107,610,387	100,086,409
Cash and cash equivalents	28,367,811	6,071,460
Finance contracts, net of allowance for credit losses of $282,484 in 2006 and $419,445 in 2005, and net of unearned finance charges of $217,663 in 2006 and $379,212 in 2005	4,839,079	7,312,736
Prepaid reinsurance premiums	3,462,162	12,133,734
Premiums receivable, net of allowance for credit losses of $173,151 and $158,151, respectively	10,284,594	7,505,631
Reinsurance recoverable, net	51,874,304	136,675,703
Deferred policy acquisition costs	9,827,913	9,183,654
Deferred income taxes, net	4,310,424	2,703,978
Property, plant and equipment, net	1,391,745	3,901,385
Other assets	5,111,466	4,580,063
Total assets	$ 227,079,885	$ 290,154,753
LIABILITIES AND SHAREHOLDERS' EQUITY		
Unpaid losses and LAE	$ 53,797,413	$ 154,038,543
Unearned premiums	66,969,112	61,839,051
Premiums deposits	2,535,176	2,144,863
Revolving credit outstanding	57,376	196,943
Bank overdraft	30,714,130	12,237,735
Funds held under reinsurance treaties	1,544,544	1,544,544
Income taxes payable	4,211,950	3,019,696
Subordinated debt	8,541,666	10,208,333
Deferred gain from sale of property	2,789,379	—
Accounts payable and accrued expenses	2,705,869	4,157,675
Total liabilities	173,866,615	249,387,383
Shareholders' equity:		
Common stock, $0.01 par value. Authorized 37,500,000 shares; issued 7,364,838 and		

7,468,713 shares, respectively; Outstanding 7,364,838 and 6,771,864, respectively		73,650		74,688
Additional paid-in capital		38,872,092		31,825,053
Accumulated other comprehensive (deficit)		(1,266,875)		(1,537,243)
Retained earnings		15,534,403		10,404,872
Total shareholders' equity		53,213,270		40,767,370
Total liabilities and shareholders' equity	$	227,079,885	$	290,154,753

SEE ACCOMPANYING NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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21ST CENTURY HOLDING COMPANY
CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2005
Revenue:		
Gross premiums written	$ 35,609,073	$ 30,097,044
Gross premiums ceded	—	(2,901,291)
Net premiums written	35,609,073	27,195,753
Decrease in prepaid reinsurance premiums	(8,671,572)	(2,675,295)
(Increase) in unearned premiums	(5,130,061)	(5,685,560)
Net change in prepaid reinsurance premiums and unearned premiums	(13,801,633)	(8,360,855)
Net premiums earned	21,807,440	18,834,898
Finance revenue	636,026	1,104,530
Managing general agent fees	657,968	632,315
Net investment income	1,196,265	892,871
Net realized investment gains	196,211	159,523
Other income	620,799	242,469
Total revenue	25,114,709	21,866,606
Expenses:		
Loss and loss adjustment expense	7,568,843	6,909,997
Operating and underwriting expenses	2,304,245	1,582,531
Salaries and wages	1,837,961	1,578,581
Interest expense	228,884	430,144
Policy acquisition costs, net of amortization	3,918,052	3,825,601
Total expenses	15,857,985	14,326,854
Income from continuing operations before provision for income tax expense	9,256,724	7,539,752
Provision for income tax expense	3,243,412	2,754,076
Net income from continuing operations	6,013,312	4,785,676
Discontinued operations:		
Income from discontinued operations (including gain on disposal of $0 and $1,630,000, respectively)	—	1,630,000
Provision for income tax expense	—	595,396
Income from discontinued operations	—	1,034,604
Net income	$ 6,013,312	$ 5,820,280

Basic net income per share from continuing operations	$	0.88	$	0.78
Basic net income per share from discontinued operations	$	—	$	0.17
Basic net income per share	$	0.88	$	0.95
Fully diluted net income per share from continuing operations	$	0.83	$	0.73
Fully diluted net income per share from discontinued operations	$	—	$	0.16
Fully diluted net income per share	$	0.83	$	0.89
Weighted average number of common shares outstanding		6,844,859		6,152,548
Weighted average number of common shares outstanding (assuming dilution)		7,238,311		6,532,023
Dividends declared per share	$	0.12	$	0.08

SEE ACCOMPANYING NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

21ST CENTURY HOLDING COMPANY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Three months ended March 31 2006	2005
Cash flow from operating activities:		Restated - See note 10
Net income	$ 6,013,312	$ 4,785,676
Adjustments to reconcile net income to net cash provided by (used for) operating activities:		
Amortization of investment discount, net	(67,385)	(53,210)
Depreciation and amortization of property plant and equipment, net	90,846	120,725
Net realized investment gains	196,211	213,756
Common Stock issued for interest on Notes	—	315,625
Provision for credit losses, net	30,524	393,762
Provision (recovery) for uncollectible premiums receivable	15,000	(374,470)
Non-cash compensation	156,694	—
Tax benefit related to non-cash compensation	(58,964)	—
Changes in operating assets and liabilities:		
Premiums receivable	(2,793,963)	(1,745,075)
Prepaid reinsurance premiums	8,671,572	2,675,295
Due from reinsurers, net	84,801,399	2,224,287
Income taxes recoverable	—	4,066,684
Deferred income tax expense	(1,606,446)	726,008
Policy acquisition costs, net of amortization	(644,259)	(742,237)
Finance contracts receivable	2,443,133	(1,831,904)
Other assets	2,257,976	297,067
Unpaid losses and loss adjustment expenses	(100,241,130)	(19,804,284)
Unearned premiums	5,130,061	5,685,560
Premium deposits	390,313	1,006,983
Income taxes payable	1,192,254	—
Bank overdraft	18,476,396	(3,691,368)
Accounts payable and accrued expenses	(1,451,807)	(1,088,794)
Net cash provided by (used for) operating activities - continuing operations	23,001,737	(6,819,914)
Net cash provided by (used for) operating activities - discontinued operations	—	(1,380,265)
Net cash provided by (used for) operating activities	23,001,737	(8,200,179)
Cash flow (used in) provided by investing activities:		
Proceeds from sale of investment securities available for sale	103,867,819	81,245,978
Purchases of investment securities available for sale	(111,406,949)	(77,438,691)
Purchases of property and equipment	(244,136)	(104,749)
Proceeds from sale of assets	2,662,930	—
Net cash (used in) provided by investing activities - continuing operations	(5,120,336)	3,702,538
Net cash (used in) provided by investing activities - discontinued operations	—	1,689,129
Net cash (used in) provided by investing activities	(5,120,336)	5,391,667

Cash flow provided by financing activities:		
Subordinated debt repaid	(1,666,667)	—
Exercised stock options	1,081,815	994,078
Dividends paid	(883,781)	(506,749)
Exercised warrants, net	5,964,186	—
Tax benefit related to non-cash compensation	58,964	—
Revolving credit outstanding	(139,567)	(125,301)
Net cash provided by financing activities - continuing operations	4,414,950	362,028
Net increase (decrease) in cash and cash equivalents	22,296,351	(2,446,484)
Cash and cash equivalents at beginning of period	6,071,460	6,127,706
Cash and cash equivalents at end of period	$ 28,367,811	$ 3,681,222

SEE ACCOMPANYING NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

21ST CENTURY HOLDING COMPANY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

(continued)	Three months ended March 31,	
Supplemental disclosure of cash flow information:	**2006**	**2005**
Cash paid during the period for:		
Interest	$ 156,824	$ 36,188
Non-cash investing and finance activities:		
Accrued dividends payable	$ 761,809	$ 445,103
Retirement of subordinated debt by Common Stock issuance	$ —	$ 1,666,667
Stock issued to pay interest on subordinated debt	$ —	$ 315,625

SEE ACCOMPANYING NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

21st Century Holding Company
Notes to Consolidated Financial Statements

(1) Organization and Business

The accompanying unaudited consolidated financial statements of 21st Century Holding Company (the "Company") have been prepared in accordance with generally accepted accounting principles ("GAAP") for interim financial information and with the instructions for Form 10-Q and Rule 10-01 of Regulation S-X. These financial statements do not include all information and notes required by GAAP for complete financial statements, and should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2005. The December 31, 2005 year-end balance sheet data was derived from audited financial statements but does not include all disclosures required by GAAP. The financial information furnished reflects all adjustments, consisting only of normal recurring accruals, which are, in the opinion of management, necessary for a fair presentation of the financial position, results of operations and cash flows for the periods presented. The results of operations are not necessarily indicative of the results of operations that may be achieved in the future.

21st Century Holding Company ("21st Century," "the Company", "we," "us") is an insurance holding company, which, through our subsidiaries and our contractual relationships with our independent agents and general agents, controls substantially all aspects of the insurance underwriting, distribution and claims process. We are authorized to underwrite personal automobile insurance, commercial general liability insurance, homeowners' property and casualty insurance and mobile home property and casualty insurance in various states with various lines of authority through our wholly owned subsidiaries, Federated National Insurance Company ("Federated National") and American Vehicle Insurance Company ("American Vehicle").

Federated National is authorized to underwrite personal automobile insurance, homeowners' property and casualty insurance and mobile home property and casualty insurance in Florida as an admitted carrier. American Vehicle is authorized to underwrite personal and commercial automobile insurance and commercial general liability insurance in Florida as an admitted carrier. In addition, American Vehicle is authorized to underwrite commercial general liability insurance in Georgia, Kentucky, South Carolina and Virginia as a surplus lines carrier and in Texas, Louisiana and Alabama as an admitted carrier. American Vehicle operations in Florida, Georgia and Louisiana are on-going. American Vehicle operations in Texas, Alabama, Kentucky, South Carolina and Virginia are expected to begin this year. American Vehicle has pending applications, in various stages of approval, to be authorized as a surplus lines carrier in the states of Connecticut, Illinois, Missouri, Nevada, New Mexico, West Virginia, California and Arkansas.

During the three months ended March 31, 2006, 64.9%, 23.1% and 12.0% of the premiums we underwrote were for homeowners' property and casualty insurance, commercial general liability insurance and personal automobile insurance, respectively. During the three months ended March 31, 2005, 52.9%, 17.1% and 30.0% of the premiums we underwrote were for homeowners' property and casualty insurance, commercial general liability insurance and personal automobile insurance, respectively. We internally process claims made by our own and third-party insureds through our wholly owned claims adjusting company, Superior Adjusting, Inc. ("Superior). We also offer premium financing to our own and third-party insureds through our wholly owned subsidiary, Federated Premium.

We market and distribute our own and third-party insurers' products and our other services primarily in Central and South Florida, through contractual relationships with a network of approximately 1,500 independent agents and a select number of general agents.

Assurance Managing General Agents, Inc. ("Assurance MGA"), a wholly owned subsidiary, acts as Federated National's and American Vehicle's exclusive managing general agent in the state of Florida. As American Vehicle continues its expansion into other states we expect to contract with other managing general agents to market our commercial general liability insurance product beyond the state of Florida. Assurance MGA currently provides all underwriting policy administration, marketing, accounting and financial services to Federated National and American Vehicle, and participates in the negotiation of reinsurance contracts. Assurance MGA generates revenue through a 6% commission fee from the insurance company's net written premium, policy fee income of $25 per policy and other administrative fees from the marketing of companies' products through the Company's distribution network. The 6% commission fee from Federated National and American Vehicle was made effective January 1, 2005. Assurance MGA plans to establish relationships with additional carriers and add additional insurance products in the future.

21st Century Holding Company
Notes to Consolidated Financial Statements

(2) Summary of Significant Accounting Policies and Practices

(A) Critical Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions about future events that affect the amounts reported in the financial statements and accompanying notes. Future events and their effects cannot be determined with absolute certainty. Therefore, the determination of estimates requires the exercise of judgment. Actual results inevitably will differ from those estimates, and such differences may be material to the financial statements.

The most significant accounting estimates inherent in the preparation of our financial statements include estimates associated with management's evaluation of the determination of liability for unpaid loss and loss adjustment expense ("LAE'), the amount and recoverability of amortization of deferred policy acquisition costs. In addition, significant estimates form the bases for our reserves with respect to finance contracts, premiums receivable and deferred income taxes. Various assumptions and other factors underlie the determination of these significant estimates. The process of determining significant estimates is fact specific and takes into account factors such as historical experience, current and expected economic conditions, and in the case of unpaid loss and LAE, an actuarial valuation. Management regularly reevaluates these significant factors and makes adjustments where facts and circumstances dictate. In selecting the best estimate, we utilize up to 6 different actuarial methodologies. Each of these methodologies is designed to forecast the number of claims we will be called upon to pay and the amounts we will pay on average to settle those claims. In arriving at our best estimate, our actuaries consider the likely predictive value of the various loss development methodologies employed in light of underwriting practices, premium rate changes and claim settlement practices that may have occurred, and weight the credibility of each methodology. Our actuarial methodologies take into account various factors, including, but not limited to, paid losses, liability estimates for reported losses, paid allocated loss adjustment expenses, salvage and other recoveries received, reported claim counts, open claim counts and counts for claims closed with and without payment of loss.

Accounting for loss contingencies pursuant to Statements of Financial Accounting Standards ("SFAS"), No.5 involves the existence of a condition, situation or set of circumstances involving uncertainty as to possible loss that will ultimately be resolved when one or more future event(s) occur or fail to occur. Additionally, accounting for a loss contingency requires management to assess each event as probable, reasonably possible or remote. Probable is defined as the future event or events are likely to occur. Reasonably possible is defined as the chance of the future event or events occurring is more than remote but less than probable, while remote is defined as the chance of the future event or events occurring is slight. An estimated loss in connection with a loss contingency shall be recorded by a charge to current operations if both of the following conditions are met: First, the amount can be reasonably estimated; and second, the information available prior to issuance of the financial statements indicates that it is probable that a liability has been incurred at the date of the financial statements. It is implicit in this condition that it is probable that one or more future events will occur confirming the fact of the loss or incurrence of a liability.

(B) Impact of New Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board ("FASB") revised SFAS No. 123, Share-Based Payments ("SFAS No. 123R"). This statement eliminates the option to apply the intrinsic value measurement provisions of the Accounting Principles Board ("APB") No. 25 to stock compensation awards issued to employees. Rather, SFAS No. 123R requires companies to measure the cost of employee services received in exchange for an award of equity instruments based on the grant date fair value of the award. That cost will be recognized over the period during which an employee is required to provide services in exchange for the award the requisite service period (usually the vesting period). SFAS No. 123R will also require companies to measure the cost of employee services received in exchange for employee stock purchase plan awards. SFAS No. 123R was effective for 21st Century's fiscal year beginning January 1, 2006 as subsequently extended by the SEC pursuant to its April 13, 2005 announcement. We have determined that the pretax charge to earnings for the year ending 2006 will total approximately $0.6 million, of which approximately $0.2 million was charged to income from continuing operations before provision for income taxes for the three months ending March 31, 2006. The effect on earnings per share for the period ended March 31, 2006 for both undiluted and fully diluted was approximately $0.01 per share. For a more detailed discussion, please see Footnote 8, titled Stock Compensation Plans.

21st Century Holding Company
Notes to Consolidated Financial Statements

(C) Stock Options

At March 31, 2006, the Company has three stock-based employee compensation plans, which are described later in footnote 8, Stock Compensation Plans. Prior to January 1, 2006, we accounted for those plans under the recognition and measurement provisions of stock-based compensation using the intrinsic value method prescribed by APB Opinion No. 25, *Accounting for Stock Issued to Employees,* and related Interpretations, as permitted by FASB Statement No. 123, *Accounting for Stock-Based Compensation.* Under these provisions, no stock-based employee compensation cost was recognized in the Statement of Operations for the year ended December 31, 2005 as all options granted under those plans had an exercise price equal to or less than the market value of the underlying common stock on the date of grant. Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123R using the modified-prospective-transition method. Under that transition method, compensation cost recognized in the first quarter of 2006 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of Statement 123, and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair-value estimated in accordance with the provisions of SFAS No. 123R. Results for prior periods have not been restated. There were no stock options granted during the three months ended March 31, 2006 and additional stock option awards are not anticipated in future years. For a further discussion regarding the provisions of SFAS No. 123R and its effect on our operations, please refer to footnote 8, Stock Compensation Plans.

(D) Earnings Per Share

Basic earnings per share ("Basic EPS") is computed by dividing net income by the weighted average number of common shares outstanding during each period presented. Diluted earnings per share ("Diluted EPS") is computed by dividing net income by the weighted average number of shares of common stock and common stock equivalents outstanding during the period presented; outstanding warrants and stock options are considered common stock equivalents and are included in the calculation using the treasury stock method. Additionally, when applicable, we include in our computation of the weighted average number of common shares outstanding all common stock issued in connection with the repayment of our Subordinated note.

(E) Reclassifications

Certain amounts in 2005 financial statements have been reclassified to conform to the 2006 presentation.

(3) Revolving Credit Outstanding

Federated Premium's operations are funded by a revolving loan agreement ("Revolving Agreement") with FlatIron Funding Company. LLC ("FlatIron"). The Revolving Agreement is structured as a sale of contracts receivable under a sale and assignment agreement with Westchester Premium Acceptance Corporation ("WPAC"), a wholly-owned subsidiary of FlatIron, which gives WPAC the right to sell or assign these contracts receivable. Federated Premium, which services these contracts, has recorded transactions under the Revolving Agreement as secured borrowings.

The amounts of WPAC's advances are subject to availability under a borrowing base calculation, with maximum advances outstanding not to exceed the maximum credit commitment. The annual interest rate on advances under the Revolving Agreement equals the prime rate plus additional interest varying from 1.25% to 3.25% based on the prior month's ratio of contracts receivable related to insurance companies with an A. M. Best rating of B or lower, to total contracts receivable. The effective interest rate on this line of credit, based on our average outstanding borrowings under the Revolving Agreement, was 11.64% and 6.94% for the three months ended March 31, 2006 and 2005, respectively.

Outstanding borrowings under the Revolving Agreement as of March 31, 2006 were approximately $57,000. Outstanding borrowings as of December 31, 2005 were approximately $197,000. Interest expense on this revolving credit line for the three months ended March 31, 2006 and March 31, 2005 totaled approximately $3,700 and $36,000, respectively.

21st Century Holding Company
Notes to Consolidated Financial Statements

(4) Commitments and Contingencies

We are involved in other claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on our consolidated financial position, results of operations, or liquidity.

As a direct premium writer in the State of Florida, we are required to participate in certain insurer solvency association under Florida Statutes 631.57(3) (a). Participation in these pools is based on our written premium by line of business to total premiums written statewide by all insurers. Participation may result in assessments against us. There was no assessment made for the year ended December 31, 2005 or through the date of this report.

Federated National and American Vehicle are also required to participate in an insurance apportionment plan under Florida Statutes Section 627.351, which is referred to as a JUA Plan. The JUA Plan provides for the equitable apportionment of any profits realized, or losses and expenses incurred, among participating motor vehicle insurers. In the event of an underwriting deficit incurred by the JUA Plan which is not recovered through the policyholders in the JUA Plan, such deficit shall be recovered from the companies participating in the JUA Plan in the proportion that the net direct written premiums of each such member during the preceding calendar year bear to the aggregate net direct premiums written in this state by all members of the JUA Plan. Federated National and American Vehicle were assessed $44,350 and $1,615, respectively by the JUA Plan based on its July 2005 Cash Activity Report. Future assessments by this association are undeterminable at this time.

During its regularly scheduled meeting on August 17, 2005, the Board of Governors of Citizens Property Insurance Corporation “Citizens” determined a 2004 plan year deficit existed in the High Risk Account. The Board decided that a $515 million Regular Assessment is in the best interest of Citizens and consistent with Florida Statutes. On this basis, the Board certified for a Regular Assessment. Federated National’s participation in this assessment totaled $2.0 million. Provisions contained in our excess of loss reinsurance policies provide for their participation totaling $1.5 million. Pursuant to Section 627.3512, Florida Statutes, insurers are permitted to recoup the assessment by adding a surcharge to policies in an amount not to exceed the amount paid by the insurer to Citizens. Federated National is currently underwriting the recoupment in connection with this assessment began in March 2006. As noted above, Federated National is entitled to recoup this assessment, and will subrogate $1.5 million to our reinsurers.

The Florida Office of Insurance Regulation (“OIR”) issued OIR-06-008M dated May 4th 2006 to all property and casualty, Surplus lines Insurers, and Surplus Lines Agents in the state of Florida placing them on notice of an anticipated Florida Hurricane Catastrophic Fund (“FHCF”) assessment. Sighting the unprecedented hurricane seasons of 2004 and 2005, the FHCF has exhausted nearly all of the $6 billion in reserves it has accumulated since its inception in 1993. The OIR anticipates the Florida State Board of Administration, the body that oversees the FHCF, will issue its directive to levy an emergency assessment upon all property and casualty business in the state of Florida near the end of May 2006.

Effective on or about March 1, 2006, 21st Century sold its interest in the Lauderdale Lakes property to an unrelated party. As part of this transaction, 21st Century has agreed to lease the same facilities for a six year term. Our lease for this office space expires in December 2011.

The expected future lease payouts in connection with this lease are as follows:

21st Century Holding Company
Notes to Consolidated Financial Statements

Fiscal Year		Lease payments
2006	$	418,187
2007		557,583
2008		557,583
2009		557,583
2010		557,583
Thereafter		557,583
Total	$	3,206,102

(5) Comprehensive Income

For the three months ended March 31, 2006 and 2005, comprehensive income consisted of the following:

	For the three months ended March 31,			
		2006		2005
Net income	$	6,013,312	$	5,820,280
Change in net unrealized gains on investments available for sale		182,260		(737,566)
Comprehensive income, before tax		6,195,572		5,082,714
Income tax (expense) benefit related to items of other comprehensive income		(68,585)		278,520
Comprehensive income	$	6,126,987	$	5,361,234

(6) Segment Information

FASB Statement No. 131, Disclosures About Segments of an Enterprise and Related Information, requires that the amount reported for each segment item be based on what is used by the chief operating decision maker in formulating a determination as to how many resources to assign to a segment and how to appraise the performance of that segment. The term chief operating decision maker may apply to the chief executive officer or chief operating officer or to a group of executives. Note: The term of chief operating decision maker may apply to a function and not necessarily to a specific person. This is a management approach rather than an industry approach in identifying segments. The segments are based on the company’s organizational structure, revenue sources, nature of activities, existence of responsible managers, and information presented to the Board of Directors.

If any one of the following exists, a segment must be reported on:

- Revenue, including unaffiliated and inter-segment sales or transfers, is 10% or more of total revenue of all operating segments.
- Operating profit or loss is 10% or more of the greater, in absolute amount, of the combined operating profit (or loss) of all industry segments with operating profits (or losses).
- Identifiable assets are 10% or more of total assets of all operating segments.

Operating segments that are not reportable should be combined and disclosed in the ‘‘all other’’ category. Disclosure should be made of the sources of revenue for these segments.

Accordingly, we have discontinued our segment disclosures due to the finance segment not exceeding the 10% threshold for revenues, earnings or assets.

(7) Reinsurance Agreements

We follow industry practice of reinsuring a portion of our risks and paying for that protection based upon premiums received on all policies subject to such reinsurance. Reinsurance involves an insurance company transferring or "ceding" all or a portion of its exposure on insurance underwritten by it to another insurer, known as a "reinsurer.” The ceding of insurance does not legally discharge the insurer from its primary liability for the full amount of the policies. If the reinsurer fails to meet its obligations under the reinsurance agreement, the ceding company is still required to pay the loss.

21st Century Holding Company
Notes to Consolidated Financial Statements

For the 2005-2006 hurricane season, the excess of loss treaties will insure us for approximately $64.0 million, with the Company retaining the first $3.0 million of loss and LAE. The treaties have one full reinstatement provision for each excess layer with 100% additional premium as to time and pro rata as to amount. In addition, we purchased, from the private sector, Reinstatement Premium Protection which will reimburse the Company 100% of the cost of reinstatement for the second event. Unused coverage from the first two events carries forward to events beyond the second, in conjunction with a lowered attachment point (as explained below) afforded by the FHCF.

In addition to the excess of loss reinsurance policies (described above), we continue to participate in the FHCF to protect our interest in the insurable risks associated with our homeowner and mobile home owner insurance products. For the first two events, FHCF coverage begins after the Company's retention of $3.0 million and its excess of loss reinsures retention of approximately $40.3 million.

Maximum coverage afforded from the combined policies of our FHCF and excess of loss policies in effect for varying dates from June 1, 2005 to June 30, 2006 total approximately $194.8 million. FHCF will retain approximately $131.0 million, our excess of loss reinsurance policies will retain $64.0 million, and the Company will retain the first $3 million of insurable losses for two events. For events beyond the second largest catastrophic event during the policy term, FHCF coverage attaches after the Company and its excess of loss reinsures collective retention of approximately $15.0 million. Additionally, unused coverage from our excess of loss reinsurance treaties may be carried forward and totals $20.0 million. However, loss and LAE incurred up to approximately $15.0 million for each hurricane subsequent to Hurricane Wilma in October 2005 and through June 30, 2006 and deemed to be a catastrophic event would be the responsibility of the Company. To date, no such catastrophic events have occurred.

As a result of the loss and LAE incurred in connection with the hurricane activity that occurred in 2004 and 2005, the Company has reflected in its operations the effects of each storm as follows:

2004 Hurricanes	Claim Count	Gross Losses	Reinsurance Recoveries	Net Losses
			(Dollars in millions)	
Charley (August 13)	2,567	$ 59.5	$ 49.5	$ 10.0
Frances (September 3)	3,805	50.2	40.2	10.0
Ivan (September 14)	1,061	21.0	-	21.0
Jeanne (September 25)	1,557	13.1	-	13.1
Total Loss Estimate	8,990	$ 143.8	$ 89.7	$ 54.1

2005 Hurricanes	Claim Count	Gross Losses	Reinsurance Recoveries	Net Losses
			(Dollars in millions)	
Dennis (July 10)	320	$ 2.7	-	$ 2.7
Katrina (August 25)	2,094	14.6	11.6	3.0
Rita (September 20)	19	0.2	-	0.2
Wilma (October 24)	11,038	137.8	134.8	3.0
Total Loss Estimate	13,471	$ 155.3	$ 146.4	$ 8.9

We are selective in choosing a reinsurer and consider numerous factors, the most important of which are the financial stability of the reinsurer, their history of responding to claims and their overall reputation. In an effort to minimize our exposure to the insolvency of a reinsurer, we evaluate the acceptability and review the financial condition of the reinsurer at least annually.

During 2005 and 2004 American Vehicle did not reinsure any of its insurance products.

21st Century Holding Company
Notes to Consolidated Financial Statements

(8) Stock Compensation Plans

We implemented a stock option plan in November 1998 that provides for the granting of stock options to officers, key employees and consultants. The objectives of this plan include attracting and retaining the best personnel, providing for additional performance incentives, and promoting our success by providing employees the opportunity to acquire common stock. Options outstanding under this plan have been granted at prices which are either equal to or above the market value of the stock on the date of grant, vest over a four-year period, and expire ten years after the grant date. Under this plan, we are authorized to grant options to purchase up to 900,000 common shares, and, as of March 31, 2006 and December 31, 2005, we had outstanding exercisable options to purchase 69,750 and 97,650 shares, respectively.

In 2001, we implemented a franchisee stock option plan that provides for the granting of stock options to individuals purchasing Company owned agencies which are then converted to franchised agencies. The purpose of the plan is to advance our interests by providing an additional incentive to encourage managers of Company owned agencies to purchase the agencies and convert them to franchises. Options outstanding under the plan have been granted at prices which are above the market value of the stock on the date of grant, vest over a ten-year period, and expire ten years after the grant date. Under this plan, we are authorized to grant options to purchase up to 988,500 common shares, though in connection with our sale of our franchise operations we do not anticipate additional options to be granted under this plan. As of March 31, 2006 and December 31, 2005, we had outstanding exercisable options to purchase -0- and 15,000 shares, respectively.

In 2002, we implemented the 2002 Option Plan. The purpose of this Plan is to advance our interests by providing an additional incentive to attract, retain and motivate highly qualified and competent persons who are key to the Company, including key employees, consultants, independent contractors, and Officers and Directors, upon whose efforts and judgment our success is largely dependent, by authorizing the grant of options to purchase Common Stock to persons who are eligible to participate hereunder, thereby encouraging stock ownership by such persons, all upon and subject to the terms and conditions of the Plan. Options outstanding under the plan have been granted at prices which are above the market value of the stock on the date of grant, vest over a five-year period, and expire six years after the grant date. Under this plan, the Company is authorized to grant options to purchase up to 1,800,000 common shares, and, as of March 31, 2006 and December 31, 2005, we had outstanding exercisable options to purchase 727,589 and 818,608 shares, respectively.

Activity in the Company’s stock option plans for the period from January 1, 2005 to March 31, 2006, is summarized below:

	1998 Plan		2001 Franchisee Plan		2002 Plan	
	Number of Shares	Weighted Average Option Exercise Price	Number of Shares	Weighted Average Option Exercise Price	Number of Shares	Weighted Average Option Exercise Price
Outstanding at January 1, 2005	198,275	$ 6.67	15,000	$ 9.17	906,300	$ 10.80
Granted	—		—		446,500	$ 14.39
Exercised	(96,875)	$ 6.67	—	$ —	(271,542)	$ 8.96
Cancelled	(3,750)	$ 6.67	—		(262,650)	$ 14.00

Outstanding at January 1, 2006	97,650	$	6.67	15,000	$	9.17	818,608	$	12.35
Granted	—			—			—	$	—
Exercised	(27,900)	$	6.67	(15,000)	$	9.17	(82,319)	$	9.22
Cancelled	—	$	6.67	—			(8,700)	$	10.35
Outstanding at March 31, 2006	69,750	$	6.67	—	$	—	727,589	$	12.72

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21st Century Holding Company
Notes to Consolidated Financial Statements

Options outstanding as of March 31, 2006 are exercisable as follows:

	1998 Plan		2001 Franchisee Plan		2002 Plan	
Options Exercisable at:	**Number of Shares**	**Weighted Average Option Exercise Price**	**Number of Shares**	**Weighted Average Option Exercise Price**	**Number of Shares**	**Weighted Average Option Exercise Price**
March 31, 2006	68,250	$ 6.67	—	$ —	283,489	$ 12.72
December 31, 2006	1,500	$ 6.67	—		112,600	$ 12.72
December 31, 2007	—		—		120,700	$ 12.72
December 31, 2008	—		—		87,100	$ 12.72
December 31, 2009	—		—		75,100	$ 12.72
December 31, 2010	—		—		48,600	$ 12.72
Thereafter	—		—		—	
Total options exercisible	69,750		—		727,589	

At March 31, 2006, the Company has three stock-based employee compensation plans, which are described above. Prior to January 1, 2006, we accounted for those plans under the recognition and measurement provisions of stock-based compensation using the intrinsic value method prescribed by APB Opinion No. 25, *Accounting for Stock Issued to Employees,* and related Interpretations, as permitted by FASB Statement No. 123, *Accounting for Stock-Based Compensation.* Under these provisions, no stock-based employee compensation cost was recognized in the Statement of Operations for the years ended December 31, 2005 or 2004 as all options granted under those plans had an exercise price equal to or less than the market value of the underlying common stock on the date of grant. Effective January 1, 2006, the Company adopted the fair value recognitions provisions of FASB Statement No. 123 (R) using the modified-prospective-transition method. Under that transition method, compensation cost recognized in the first quarter of 2006 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of Statement 123, and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair-value estimated in accordance with the provisions of SFAS No. 123R. Results for prior periods have not been restated.

As a result of adopting SFAS No. 123R on January 1, 2006, the Company's income from continuing operations before provision for income taxes and net income for the three months ended March 31, 2006, are lower by approximately $157,000 and $98,000, respectively, than if it had continued to account for share-base compensation under ABP Opinion No. 25. Basic and diluted earnings per share for the three month period ended March 31, 2006 for both basic and diluted would have been $0.89 and $0.84, respectively, if the Company had not adopted SFAS No. 123R, compared to reported basic and diluted earnings per share of $0.88 and $0.83, respectively.

Because the change in income taxes payable includes the effect of excess tax benefits, those excess tax benefits also must be shown as a separate operating cash outflow so that operating cash flows exclude the effect of excess tax benefits. SFAS No. 123R requires the cash flows resulting from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of Statement 123 to options granted under our stock option plans in the period presented. For purposes of this provision disclosure and comparability, the value of the options were estimated using the Black-Scholes option-pricing model and amortized to expense over the options vesting periods.

21st

(68

)

Net cash provided by operating activities

10,707

22,171

Investing activities:

Purchase of property, plant and equipment

(241

)

(883

)

Proceeds from disposal of property, plant and equipment

—

4

Purchase of investments

(39,000

)

(36,000

)

Redemption of investments at maturity

45,000

27,000

Net cash provided (used) by investing activities

5,759

(9,879

)

Financing activities:

Principal repayments on capital lease obligations

(38

)

(42

)

Issuance of common stock

79

97

Dividends paid

(2,616

)

(2,415

)

Purchase of treasury stock

(29

)

(5,852

)

Excess tax (deficiency) benefit on stock awards

(26

)

5

Net cash used by financing activities

(2,630

)

(8,207

)

Effect of exchange rate changes on cash

(231

)

(141

)

Net increase in cash and cash equivalents

13,605

3,944

Cash and cash equivalents at beginning of year

24,072

27,271

Cash and cash equivalents at end of period

$

37,677

$

31,215

See Notes to Condensed Consolidated Financial Statements.

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GRAHAM CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(Amounts in thousands, except per share data)

NOTE 1 – BASIS OF PRESENTATION:

Graham Corporation's (the "Company's") Condensed Consolidated Financial Statements include its (i) wholly-owned foreign subsidiary located in Suzhou, China and (ii) wholly-owned domestic subsidiary located in Lapeer, Michigan. The Condensed Consolidated Financial Statements have been prepared in accordance with accounting principles generally accepted in the U.S. ("GAAP") for interim financial information and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X, each as promulgated by the Securities and Exchange Commission. The Company's Condensed Consolidated Financial Statements do not include all information and notes required by GAAP for complete financial statements. The unaudited Condensed Consolidated Balance Sheet as of March 31, 2016 presented herein was derived from the Company’s audited Consolidated Balance Sheet as of March 31, 2016. For additional information, please refer to the consolidated financial statements and notes included in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2016 ("fiscal 2016"). In the opinion of management, all adjustments, including normal recurring accruals considered necessary for a fair presentation, have been included in the Company's Condensed Consolidated Financial Statements.

The Company's results of operations and cash flows for the three and nine months ended December 31, 2016 are not necessarily indicative of the results that may be expected for the current fiscal year, which ends March 31, 2017 ("fiscal 2017").

NOTE 2 – REVENUE RECOGNITION:

The Company recognizes revenue on all contracts with a planned manufacturing process in excess of four weeks (which approximates 575 direct labor hours) using the percentage-of-completion method. The majority of the Company's revenue is recognized under this methodology. The Company has established the systems and procedures essential to developing the estimates required to account for contracts using the percentage-of-completion method. The percentage-of-completion method is determined by comparing actual labor incurred to a specific date to management's estimate of the total labor to be incurred on each contract or completion of operational milestones assigned to each contract. Contracts in progress are reviewed monthly by management, and sales and earnings are adjusted in current accounting periods based on revisions in the contract value and estimated costs at completion. Losses on contracts are recognized immediately when evident to management.

Revenue on contracts not accounted for using the percentage-of-completion method is recognized utilizing the completed contract method. The majority of the Company's contracts (as opposed to revenue) have a planned manufacturing process of less than four weeks and the results reported under this method do not vary materially from the percentage-of-completion method. The Company recognizes revenue and all related costs on these contracts upon substantial completion or shipment to the customer. Substantial completion is consistently defined as at least 95% complete with regard to direct labor hours. Customer acceptance is generally required throughout the construction process and the Company has no further material obligations under its contracts after the revenue is recognized.

Receivables billed but not paid under retainage provisions in the Company’s customer contracts were $859 and $2,071 at December 31, 2016 and March 31, 2016, respectively.

NOTE 3 – INVESTMENTS:

Investments consist of certificates of deposits with financial institutions. All investments have original maturities of greater than three months and less than one year and are classified as held-to-maturity, as the Company believes it has the intent and ability to hold the securities to maturity. Investments are stated at amortized cost which approximates fair value. All investments held by the Company at December 31, 2016 are scheduled to mature on or before September 14, 2017.

NOTE 4 – INVENTORIES:

Inventories are stated at the lower of cost or market, using the average cost method. Unbilled revenue in the Condensed Consolidated Balance Sheets represents revenue recognized that has not been billed to customers on contracts accounted for on the percentage-of-completion method. For contracts accounted for on the percentage-of-completion method, progress payments are netted against unbilled revenue to the extent the payment is less than the unbilled revenue for the applicable contract. Progress payments exceeding unbilled revenue are netted against inventory to the extent the payment is less than or equal to the inventory balance relating to the applicable contract, and the excess is presented as customer deposits in the Condensed Consolidated Balance Sheets.

Major classifications of inventories are as follows:

	December 31, 2016	March 31, 2016
Raw materials and supplies	$ 3,159	$ 3,178
Work in process	11,296	11,615
Finished products	978	659
	15,433	15,452
Less - progress payments	6,324	4,641
Total	$ 9,109	$ 10,811

NOTE 5 – INTANGIBLE ASSETS:

Intangible assets are comprised of the following:

	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
At December 31, 2016			
Intangibles subject to amortization:			
Customer relationships	$ 2,700	$ 1,087	$ 1,613
Intangibles not subject to amortization:			
Permits	$ 10,300	$ —	$ 10,300
Tradename	2,500	—	2,500
	$ 12,800	$ —	$ 12,800
At March 31, 2016			
Intangibles subject to amortization:			
Customer relationships	$ 2,700	$ 952	$ 1,748
Intangibles not subject to amortization:			
Permits	$ 10,300	$ —	$ 10,300
Tradename	2,500	—	2,500

	$ 12,800	$ —	$ 12,800

Intangible assets are amortized on a straight line basis over the estimated useful lives. Intangible amortization expense for each of the three-month periods ended December 31, 2016 and 2015was $45. Intangible amortization expense for each of the nine-month periods ended December 31, 2016 and 2015 was $135. As of December 31, 2016, amortization expense is estimated to be $45 for the remainder of fiscal 2017 and $180 in each of the fiscal years ending March 31, 2018, 2019, 2020 and 2021.

NOTE 6 – STOCK-BASED COMPENSATION:

The Amended and Restated 2000 Graham Corporation Incentive Plan to Increase Shareholder Value, as approved by the Company's stockholders at the Annual Meeting on July 28, 2016, provides for the issuance of up to 1,375 shares of common stock in connection with grants of incentive stock options, non-qualified stock options, stock awards and performance awards to officers, key employees and outside directors. As of December 31, 2016, 310 shares remain available for future awards under the plan, 225 of which may be used for awards other than stock options. Stock options may be granted at prices not less than the fair market value at the date of grant and expire no later than ten years after the date of grant.

No restricted stock awards were granted in the three-month periods ended December 31, 2016 and 2015. Restricted stock awards granted in the nine-month periods ended December 31, 2016 and 2015 were 82 and 34, respectively. Restricted shares of 43 and 15 granted to officers in fiscal 2017 and fiscal 2016, respectively, vest 100% on the third anniversary of the grant date subject to the satisfaction of the performance metrics for the applicable three-year period. Restricted shares of 31 and 12 granted to officers and key employees in fiscal 2017 and fiscal 2016, respectively, vest 33 % per year over a three-year term. Restricted shares of 8 and 7 granted to directors in fiscal 2017 and fiscal 2016, respectively, vest 100% on the first year anniversary of the grant date. No stock option awards were granted in the three-month or nine-month periods ended December 31, 2016 and 2015.

During the three months ended December 31, 2016 and 2015, the Company recognized stock-based compensation costs related to stock option and restricted stock awards of $200 and $148, respectively. The income tax benefit recognized related to stock-based compensation was $70 and $52 for the three months ended December 31, 2016 and 2015, respectively. During the nine months ended December 31, 2016 and 2015, the Company recognized stock-based compensation costs related to stock option and restricted stock awards of $427 and $505, respectively. The income tax benefit recognized related to stock-based compensation was $151 and $178 for the nine months ended December 31, 2016 and 2015, respectively.

The Company has an Employee Stock Purchase Plan (the "ESPP"), which allows eligible employees to purchase shares of the Company's common stock at a discount of up to 15% of its fair market value on the (1) last, (2) first or (3) lower of the last or first day of the six-month offering period. A total of 200 shares of common stock may be purchased under the ESPP. During the three months ended December 31, 2016 and 2015, the Company recognized stock-based compensation costs of $0 and $14, respectively, related to the ESPP and $0 and $5, respectively, of related tax benefits. During the nine months ended December 31, 2016 and 2015, the Company recognized stock-based compensation costs of $6 and $35, respectively, related to the ESPP and $2 and $13, respectively, of related tax benefits.

NOTE 7 – INCOME PER SHARE:

Basic income per share is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted income per share is calculated by dividing net income by the weighted average number of common shares outstanding and, when applicable, potential common shares outstanding during the period. A reconciliation of the numerators and denominators of basic and diluted income per share is presented below:

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2016	2015	2016	2015
Basic income per share				
Numerator:				
Net income	$1,840	$1,274	$3,222	$5,611
Denominator:				
Weighted average common shares outstanding	9,727	9,922	9,709	10,051
Basic income per share	$.19	$.13	$.33	$.56
Diluted income per share				
Numerator:				
Net income	$1,840	$1,274	$3,222	$5,611
Denominator:				
Weighted average common shares outstanding	9,727	9,922	9,709	10,051

Stock options outstanding	6	5	5	8
Weighted average common and potential common				
shares outstanding	9,733	9,927	9,714	10,059
Diluted income per share	$.19	$.13	$.33	$.56

Options to purchase a total of 16 and 54 shares of common stock were outstanding at December 31, 2016 and 2015, respectively, but were not included in the above computation of diluted income per share given their exercise prices as they would not be dilutive upon issuance.

NOTE 8 – PRODUCT WARRANTY LIABILITY:

The reconciliation of the changes in the product warranty liability is as follows:

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2016	2015	2016	2015
Balance at beginning of period	$582	$504	$686	$653
(Income) expense for product warranties	(81)	(158)	31	(45)
Product warranty claims paid	(4)	(11)	(220)	(273)
Balance at end of period	$497	$335	$497	$335

Income of $81 and $158 for product warranties in the three months ended December 31, 2016 and 2015, respectively, and the income of $45 in the nine months ended December 31, 2015 resulted from the reversal of provisions made that were no longer required due to lower claims experience.

The product warranty liability is included in the line item "Accrued expenses and other current liabilities" in the Condensed Consolidated Balance Sheets.

NOTE 9 - CASH FLOW STATEMENT:

Interest paid was $7 and $8 in the nine-month periods ended December 31, 2016 and 2015, respectively. Income taxes paid for the nine months ended December 31, 2016 and 2015 were $104 and $4,348, respectively.

During the nine months ended December 31, 2016 and 2015, respectively, stock option awards were exercised and restricted stock awards vested. In connection with such stock option exercises and vesting, the related income tax benefit realized was (less) greater than the tax benefit that had been recorded pertaining to the compensation cost recognized by $(26) and $5, respectively, for such periods. This excess tax (deficiency) benefit has been separately reported under "Financing activities" in the Condensed Consolidated Statements of Cash Flows. Also, in the nine months ended December 31, 2016 and 2015, non-cash activities included the issuance of treasury stock valued at $107 and $124, respectively, to the Company's Employee Stock Purchase Plan.

At December 31, 2016 and 2015, respectively, there were $31 and $20 of capital purchases that were recorded in accounts payable and are not included in the caption "Purchase of property, plant and equipment" in the Condensed Consolidated Statements of Cash Flows.

NOTE 10 – EMPLOYEE BENEFIT PLANS:

The components of pension cost (benefit) are as follows:

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2016	2015	2016	2015
Service cost	$151	$130	$451	$391
Interest cost	362	360	1,087	1,078
Expected return on assets	(718)	(795)	(2,155)	(2,385)
Amortization of actuarial loss	337	293	1,013	880
Net pension cost (benefit)	$132	$(12)	$396	$(36)

The Company made no contributions to its defined benefit pension plan during the nine months ended December 31, 2016 and does not expect to make any contributions to the plan for the balance of fiscal 2017.

The components of the postretirement benefit cost are as follows:

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2016	2015	2016	2015
Interest cost	$ 5	$ 7	$ 19	$ 20
Amortization of actuarial loss	11	10	30	30
Net postretirement benefit cost	$ 16	$ 17	$ 49	$ 50

The Company paid no benefits related to its postretirement benefit plan during the nine months ended December 31, 2016. The Company expects to pay benefits of approximately $88 for the balance of fiscal 2017.

The Company self-funds the medical insurance coverage it provides to its U.S. based employees. The Company maintains a stop loss insurance policy in order to limit its exposure to claims. The liability of $178 and $176 on December 31, 2016 and March 31, 2016, respectively, related to the self-insured medical plan is primarily based upon claim history and is included in the caption “Accrued compensation” as a current liability in the Condensed Consolidated Balance Sheets.

NOTE 11 – COMMITMENTS AND CONTINGENCIES:

The Company has been named as a defendant in lawsuits alleging personal injury from exposure to asbestos allegedly contained in, or accompanying, products made by the Company. The Company is a co-defendant with numerous other defendants in these lawsuits and intends to vigorously defend itself against these claims. The claims in the Company’s current lawsuits are similar to those made in previous asbestos-related suits that named the Company as defendant, which either were dismissed when it was shown that the Company had not supplied products to the plaintiffs’ places of work or were settled for immaterial amounts.

As of December 31, 2016, the Company was subject to the claims noted above, as well as other legal proceedings and potential claims that have arisen in the ordinary course of business.

Although the outcome of the lawsuits, legal proceedings or potential claims to which the Company is, or may become, a party to cannot be determined and an estimate of the reasonably possible loss or range of loss cannot be made, management does not believe that the outcomes, either individually or in the aggregate, will have a material effect on the Company’s results of operations, financial position or cash flows.

NOTE 12 – INCOME TAXES:

The Company files federal and state income tax returns in several domestic and international jurisdictions. In most tax jurisdictions, returns are subject to examination by the relevant tax authorities for a number of years after the returns have been filed. The Company is subject to U.S. federal examination for the tax years 2014 through 2016 and examination in state tax jurisdictions for the tax years 2012 through 2016. The Company is subject to examination in the People’s Republic of China for tax years 2013 through 2015.

There was no liability for unrecognized tax benefits at each of December 31, 2016 and March 31, 2016.

NOTE 13 – CHANGES IN ACCUMULATED OTHER COMPREHENSIVE LOSS:

The changes in accumulated other comprehensive loss by component for the nine months ended December 31, 2016 and 2015 are as follows:

	Pension and Other Postretirement Benefit Items	Foreign Currency Items	Total
Balance at April 1, 2016	$ (10,932)	$ 256	$ (10,676)
Other comprehensive income before reclassifications	—	(283)	(283)
Amounts reclassified from accumulated other comprehensive loss	674	—	674
Net current-period other comprehensive income	674	(283)	391
Balance at December 31, 2016	$ (10,258)	$ (27)	$ (10,285)

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	Pension and Other Postretirement Benefit Items	Foreign Currency Items	Total
Balance at April 1, 2015	$ (9,462)	$ 406	$(9,056)
Other comprehensive income before reclassifications	—	(184)	(184)
Amounts reclassified from accumulated other comprehensive loss	589	—	589
Net current-period other comprehensive income	589	(184)	405
Balance at December 31, 2015	$ (8,873)	$ 222	$(8,651)

The reclassifications out of accumulated other comprehensive loss by component for the three and nine months ended December 31, 2016 and 2015 are as follows:

Details about Accumulated Other Comprehensive Loss Components	Amount Reclassified from Accumulated Other Comprehensive Loss Three Months Ended December 31, 2016	2015	Affected Line Item in the Condensed Consolidated Statements of Operations and Retained Earnings
Pension and other postretirement benefit items:			
Amortization of actuarial loss	$ (348) [(1)]	$ (304) [(1)]	Income before provision for income taxes
	(123)	(107)	Provision for income taxes
	$ (225)	$ (197)	Net income

Details about Accumulated Other Comprehensive Loss Components	Amount Reclassified from Accumulated Other Comprehensive Loss Nine Months Ended December 31, 2016	2015	Affected Line Item in the Condensed Consolidated Statements of Operations and Retained Earnings
Pension and other postretirement benefit items:			
Amortization of actuarial loss	$ (1,043) [(1)]	$ (911) [(1)]	Income before provision for income taxes

(369)	(322)	Provision for income taxes
$ (674)	$ (589)	Net income

(1) These accumulated other comprehensive loss components are included within the computation of pension and other postretirement benefit costs. See Note 10.

NOTE 14 – RESTRUCTURING CHARGE:

In fiscal 2017, the Company's workforce was aligned with market conditions by eliminating certain management, office and manufacturing positions. As a result, a restructuring charge of $630 was recognized, which included severance and related employee benefit costs. This charge is included in the caption "Restructuring Charge" in the Condensed Consolidated Statement of Operations and Retained Earnings for the nine months ended December 31, 2016. The reconciliation of the changes in the restructuring reserve is as follows:

	Nine Months Ended December 31, 2016
Balance at beginning of period	$ 74
Expense for restructuring	630
Amounts paid for restructuring	(549)
Balance at end of period	$ 155

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The current portion of the liability of $144 and $74 at December 31, 2016 and March 31, 2016 respectively, is included in the caption "Accrued Compensation" in the Condensed Consolidated Balance Sheets. The long-term portion of $11 at December 31, 2016 is separately presented in the Condensed Consolidated Balance Sheet.

NOTE 15 – OTHER INCOME:

During the three and nine months ended December 31, 2015, certain orders from customers were cancelled. The contracts for the cancelled orders included provisions that entitled the Company to cancellation charges. The amount of the cancellation charges were negotiated and settled with the customers. This income, net of costs incurred on the contracts, of $1,784 is presented in the caption "Other Income" in the Condensed Consolidated Statements of Operations and Retained Earnings for the three and nine months ended December 31, 2015.

NOTE 16 – ACCOUNTING AND REPORTING CHANGES:

In the normal course of business, management evaluates all new accounting pronouncements issued by the Financial Accounting Standards Board ("FASB"), the Securities and Exchange Commission, the Emerging Issues Task Force, the American Institute of Certified Public Accountants or other authoritative accounting bodies to determine the potential impact they may have on the Company's consolidated financial statements.

In May 2014, the FASB issued Accounting Standards Update ("ASU") 2014-09, "Revenue from Contracts with Customers." This guidance establishes principles for reporting information about the nature, amount, timing and uncertainty of revenue and cash flows arising from a company's contracts with customers. The guidance requires companies to apply a five-step model when recognizing revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods and services. The guidance also includes a comprehensive set of disclosure requirements regarding revenue recognition. The guidance allows two methods of adoption: (1) a full retrospective approach where historical financial information is presented in accordance with the new standard and (2) a modified retrospective approach where the guidance is applied to the most current period presented in the financial statements. In August 2015, the FASB issued ASU No 2015-14 "Revenue from Contracts with Customers: Deferral of the Effective Date," which deferred the effective date of ASU 2014-09 to annual reporting periods beginning after December 15, 2017, with earlier application permitted as of annual reporting periods beginning after December 15, 2016. In March 2016, the FASB issued ASU No. 2016-08, "Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)," to clarify the implementation guidance on principal versus agent. In April 2016, the FASB issued ASU No. 2016-10, "Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing," which clarifies the identifying performance obligations and licensing implementation guidance. In May 2016, the FASB issued ASU No. 2016-12, "Revenue from Contracts with Customers (Topic 606): Narrow Scope Improvements and Practical Expedients," which clarifies the implementation guidance related to collectability, presentation of sales tax, noncash consideration, contract modifications and completed contracts at transition. The Company is currently evaluating the impact of adopting these ASU's and the methods of adoption; however, given the scope of the new standards, the Company is currently unable to provide a reasonable estimate regarding the financial impact or which method of adoption will be elected. See Note 2 for a description of the Company's current revenue recognition policy.

In July 2015, the FASB issued ASU No. 2015-11, "Simplifying the Measurement of Inventory," which simplifies the subsequent measurement of inventory by requiring inventory to be measured 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. This ASU is effective for public business entities for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. The Company is currently evaluating the impact that the adoption of this ASU will have on its Consolidated Financial Statements.

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)," which requires companies to recognize all leases as assets and liabilities on the consolidated balance sheet. This ASU retains a distinction between finance leases and operating leases, and the classification criteria for distinguishing between finance leases and operating leases are substantially similar to the classification criteria for distinguishing between capital leases and operating leases in the current accounting guidance. As a result, the effect of leases on the consolidated statement of comprehensive income and a consolidated statement of cash flows is largely unchanged from previous generally accepted accounting principles. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Earlier application is permitted. The Company is currently evaluating the impact that the adoption of this ASU will have on its Consolidated Financial Statements.

In March 2016, the FASB issued ASU 2016-09, "Compensation—Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting." ASU 2016-09 changes how companies account for certain aspects of share-based payment awards to employees, including the accounting for income taxes, forfeitures and statutory tax withholding requirements, as well as classification in the statement of cash flows. ASU 2016-09 is effective for annual periods beginning after December 15, 2016, including interim periods within those annual periods. If an entity early adopts in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period and the entity must adopt all of the amendments from ASU 2016-09 in the same period. The Company does not expect the adoption of this ASU will have a material effect on its Consolidated Financial Statements.

In August 2016, the FASB issued ASU No. 2016-15, “Statement of Cash Flows (Topic 230),” which clarifies the presentation and classification of eight specific issues on the cash flow statement. This ASU is effective for public businesses for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. The Company does not expect the adoption of this ASU will have a material effect on its Consolidated Financial Statements.

Management does not expect any other recently issued accounting pronouncements, which have not already been adopted, to have a material impact on the Company's consolidated financial statements.

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

(Dollar amounts in thousands, except per share data)

Overview

We are a global business that designs, manufactures and sells critical equipment for the energy, defense and chemical/petrochemical industries. Our energy markets include oil refining, cogeneration, nuclear and alternative power. For the defense industry, our equipment is used in nuclear propulsion power systems for the U.S. Navy. For the chemical and petrochemical industries, our equipment is used in fertilizer, ethylene, methanol and downstream chemical facilities.

Graham's global brand is built upon our world-renowned engineering expertise in vacuum and heat transfer technology, responsive and flexible service and high quality standards. We design and manufacture custom-engineered ejectors, vacuum pumping systems, surface condensers and vacuum systems. We are also a leading nuclear code accredited fabrication and specialty machining company. We supply components used inside reactor vessels and outside containment vessels of nuclear power facilities. Our equipment can also be found in other diverse applications such as metal refining, pulp and paper processing, water heating, refrigeration, desalination, food processing, pharmaceutical, heating, ventilating and air conditioning.

Our corporate headquarters are located in Batavia, New York. We have production facilities co-located with our headquarters in Batavia and also at our wholly-owned subsidiary, Energy Steel & Supply Co. ("Energy Steel"), located in Lapeer, Michigan. We also have a wholly-owned foreign subsidiary, Graham Vacuum and Heat Transfer Technology (Suzhou) Co., Ltd. ("GVHTT"), located in Suzhou, China. GVHTT provides sales and engineering support for us in the People's Republic of China and management oversight throughout Southeast Asia.

Our current fiscal year (which we refer to as "fiscal 2017") ends March 31, 2017.

Highlights

Highlights for the three and nine months ended December 31, 2016 include:

- Net sales for the third quarter of fiscal 2017 were $22,654, up 31% compared with $17,323 for the third quarter of the fiscal year ended March 31, 2016 (we refer to the fiscal year ended March 31, 2016 as "fiscal 2016"). Net sales for the first nine months of fiscal 2017 were $66,145, down 2% compared with net sales of $67,738 for the first nine months of fiscal 2016.
- Net income and income per diluted share for the third quarter of fiscal 2017 were $1,840 and $0.19, compared with $1,274 and $0.13, respectively, for the third quarter of fiscal 2016. Net income and income per diluted share for the first nine months of fiscal 2017 were $3,222 and $0.33, respectively, compared with net income of $5,611 and income per diluted share of $0.56 for the first nine months of fiscal 2016.
-

Orders booked in the third quarter of fiscal 2017 were $17,699, down 21% compared with the third quarter of fiscal 2016 when orders were $22,263. Orders booked in the first nine months of fiscal 2017 were $57,123, down 15% compared with the first nine months of fiscal 2016, when orders were $66,840.

- Backlog was $99,104 at December 31, 2016, compared with $104,015 at September 30, 2016 and $107,963 at March 31, 2016.
- Gross profit margin and operating margin for the third quarter of fiscal 2017 were 28% and 11%, respectively, compared with 20% and 9%, respectively, for the third quarter of fiscal 2016. Gross profit margin and operating margin for the first nine months of fiscal 2017 were 23% and 6% compared with 28% and 12%, respectively, for the first nine months of fiscal 2016.
- Cash and short-term investments at December 31, 2016 were $72,677, compared with $66,274 on September 30, 2016 and $65,072 at March 31, 2016.

Forward-Looking Statements

This report and other documents we file with the Securities and Exchange Commission include “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.

These statements involve known and unknown risks, uncertainties and other factors that may cause actual results to be materially different from any future results implied by the forward-looking statements. Such factors include, but are not limited to, the risks and uncertainties identified by us under the heading "Risk Factors" in Item 1A of our Annual Report on Form 10-K for fiscal 2016.

Forward-looking statements may also include, but are not limited to, statements about:

- the current and future economic environments affecting us and the markets we serve;
- expectations regarding investments in new projects by our customers;
- sources of revenue and anticipated revenue, including the contribution from anticipated growth;
- expectations regarding achievement of revenue and profitability expectations;
- plans for future products and services and for enhancements to existing products and services;
- our operations in foreign countries;
- political instability in regions in which our customers are located;
- our ability to affect our growth and acquisition strategy;
- our ability to expand nuclear power work into new markets;
- our ability to maintain or expand nuclear power work for the U.S. Navy;
- our ability to successfully execute our existing contracts;
- estimates regarding our liquidity and capital requirements;
- timing of conversion of backlog to sales;
- our ability to attract or retain customers;
- the outcome of any existing or future litigation; and
- our ability to increase our productivity and capacity.

Forward-looking statements are usually accompanied by words such as “anticipate,” “believe,” “estimate,” “may,” “might,” “intend,” “interest,” “appear,” “expect,” “suggest,” “plan,” “encourage,” “potential” and similar expressions. Actual results co materially from historical results or those implied by the forward-looking statements contained in this report.

Undue reliance should not be placed on our forward-looking statements. Except as required by law, we undertake no obligation to update or announce any revisions to forward-looking statements contained in this report, whether as a result of new information, future events or otherwise.

Current Market Conditions

Demand for our products and services to the oil refining and chemical industries depends on capital investment for new capacity, retrofit and debottlenecking projects and for planned or unplanned maintenance activity. Increased volatility and significant reduction in global crude oil prices beginning in the second half of calendar 2014 created continuing uncertainty in the oil refining and chemical industries. Such dramatic price reduction and increased volatility in global crude oil prices together with uncertainty of the mid- and long-term outlook caused our customers in these markets to alter their investment timing over the past year. Capital investment within global refining and chemical industries contracted during fiscal 2016 compared with fiscal 2015 and has continued to contract in fiscal 2017. While oil prices have stabilized over the past two quarters and have increased since the U. S. election, the near term uncertainty has not yet changed. We continue to believe that the catalyst for increased investment would be higher or more stable crude oil prices, though a period of longer than six months is likely required. However, even if crude oil prices remain low for a sustained period, we believe that increased global energy and petrochemical demand as well as the need to maintain and replace current equipment will eventually drive additional customer investment.

Demand for our products and services in the nuclear power utility market is affected by investment in maintenance, repair, life extension and nuclear regulatory mandated investment, along with global investment in new capacity. Global investment in new capacity is affected by regional legislative policy and cost per unit of power output compared with other energy sources, such as natural gas, oil, coal or alternative energies. Because the nuclear market which we serve is very fragmented, we continue to believe that it provides an important opportunity for growth.

Demand in our naval nuclear propulsion market is tied to aircraft carrier and submarine vessel construction schedules of the primary shipyards who service the U.S. Navy. We expect growth in our naval nuclear propulsion business, based on anticipated demand and our strategic initiatives which are intended to increase our market share.

Oil refining and chemicals are expected to remain important end markets, notwithstanding the severity of the current downturn in these industries. We intend to maintain our focus in these sectors and continue to implement strategies that expand participation and our market share. We believe that long-term demand drivers for energy requirements are unchanged and have not been affected by the decline in the price of crude oil. We believe that such demand, which is driven by population growth and an expanding middle class in emerging markets, requires an increase in global energy and petrochemical capacity and investment which will be partially offset by technological innovation. Our strategy is to continue to leverage our investments and expand our capabilities and execution capacity to grow market share in the oil refining, chemical and nuclear markets, as well as our business with the U.S. Navy. For more information, refer to the heading “Strategy and Outlook” within this Item 2 of this Quarterly Report on Form 10-Q.

We believe the long-term outlook in our key markets supports our strategy to grow our revenue to over $200,000 across the next business cycle in our markets. In the near term, new order levels are expected to remain volatile, resulting in both relatively strong and weak periods.

The chart below shows the impact of our diversification strategy over the last ten years. Over 60% of our current backlog is from markets not served by us in the Fiscal 2007-2009 time frame.

Results of Operations

To better understand the significant factors that influenced our performance during the periods presented, the following discussion should be read in conjunction with our Condensed Consolidated Financial Statements and the notes to our Condensed Consolidated Financial Statements included in Part I, Item 1, of this Quarterly Report on Form 10-Q.

The following table summarizes our results of operations for the periods indicated:

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2016	2015	2016	2015
Net sales	$22,654	$17,323	$66,145	$67,738
Gross profit	$6,301	$3,524	$15,422	$18,696
Gross profit margin	28 %	20 %	23 %	28 %
SG&A expense [1]	$3,804	$3,738	$10,637	$12,622
SG&A as a percent of sales	17 %	22 %	16 %	19 %
Net income	$1,840	$1,274	$3,222	$5,611
Diluted income per share	$0.19	$0.13	$0.33	$0.56
Total assets	$148,328	$151,009	$148,328	$151,009
Total assets excluding cash, cash equivalents and investments	$75,651	$77,794	$75,651	$77,794

(1) Selling, general and administrative expense is referred to as “SG&A”.

The Third Quarter and First Nine Months of Fiscal 2017 Compared With the Third Quarter and First Nine Months

of Fiscal 2016

Sales for the third quarter of fiscal 2017 were $22,654, a 31% increase as compared with sales of $17,323 for the third quarter of fiscal 2016. Our domestic sales, as a percentage of aggregate sales, were 77% in the third quarter of fiscal 2017 compared with 62% in the third quarter of fiscal 2016. Domestic sales year-over-year increased $6,638, or 61%. International sales decreased $1,307, or 20%, in the third quarter of fiscal 2017 compared with the third quarter of fiscal 2016, driven by decreases in the Middle East and Canada. Sales in the three months ended December 31, 2016 were 28% to the refining industry, 19% to the chemical and petrochemical industries, 19% to the power industry, including the nuclear market, and 34% to other commercial and industrial applications, including the U.S. Navy. Sales in the three months ended December 31, 2015 were 36% to the refining industry, 28% to the chemical and petrochemical industries, 16% to the power industry, including the nuclear market, and 20% to other commercial and industrial applications, including the U.S. Navy. Fluctuation in sales among markets, products and geographic locations varies, sometimes significantly, from quarter-to-quarter based on timing and magnitude of projects. See also “Current Market Conditions,” above. For additional information on anticipated future sales and our markets, see "Orders and Backlog" below.

Sales for the first nine months of fiscal 2017 were $66,145, a decrease of $1,593, or 2% compared with sales of $67,738 for the first nine months of fiscal 2016. The decrease in fiscal year-to-date sales was due to much weaker international sales, especially in the Middle East and Canada, offset by an increase in domestic sales. Our domestic sales, as a percentage of aggregate product sales, were 74% in the first nine months of fiscal 2017 compared with 65% in the same period in fiscal 2016. Domestic sales increased $5,469, or 13%, while international sales decreased by $7,062, or 29%. International sales accounted for 26% and 35% of total sales for the first nine months of fiscal 2017 and fiscal 2016, respectively. Sales in the first nine months of fiscal 2017 were 31% to the refining industry, 22% to the chemical and petrochemical industries, 23% to the power industry, including the nuclear market, and 24% to other commercial and industrial applications, including the U.S. Navy. Sales in the first nine months of fiscal 2016 were 31% to the refining industry, 35% to the chemical and petrochemical industries, 14% to the power industry, including the nuclear market, and 20% to other commercial and industrial applications, including the U.S. Navy.

Our gross profit margin for the third quarter of fiscal 2017 was 28% compared with 20% for the third quarter of fiscal 2016. Gross profit for the third quarter of fiscal 2017 increased 79% compared with fiscal 2016, to $6,301 from $3,524. Gross profit and margin were favorably impacted by higher volume as well as a large non-typical order that began converting in the quarter. The third quarter of the prior year, fiscal 2016, included a very unfavorable mix of projects which were converted.

Our gross profit margin for the first nine months of fiscal 2017 was 23% compared with 28% for the first nine months of fiscal 2016. Gross profit for the first nine months of fiscal 2017 decreased 18% compared with fiscal 2016, to $15,422 from $18,696. The decrease in gross margin reflects lower pricing due to the deteriorating market conditions experienced over the past two years.

SG&A expenses as a percent of sales for the three and nine-month periods ended December 31, 2016 were 17% and 16%, respectively. SG&A expenses in the third quarter of fiscal 2017 were $3,804, an increase of $66, or 2%, compared with the third quarter of fiscal 2016 SG&A of $3,738. SG&A expenses in the first nine months of fiscal 2017 were $10,637, a decrease of $1,985, or 16%, compared with the first nine months of fiscal 2016 SG&A of $12,622. This decrease was principally due to lower commissions, lower compensation costs and other actions taken to reduce costs as well as the benefit of insurance proceeds in the second quarter.

Other income in the three and nine-month periods ended December 31, 2016 was $0. This compares to $1,784 in the three and nine-month periods ended December 31, 2015. The amount in the prior fiscal year, fiscal 2016, resulted from the cancellation charges received from customers for two orders cancelled in the year.

Interest income for the three and nine-month periods ended December 31, 2016 was $100 and $272, respectively, compared with $72 and $177, respectively, for the same periods ended December 31, 2015. Interest expense for the three and nine-month periods ended December 31, 2016 was $3 and $7, respectively, compared with $4 and $8, respectively, for the same periods ended December 31, 2015.

The effective tax rate in the current quarter was 29%, and 27% in the first nine months of fiscal 2017. The effective tax rates for the comparable three and nine month periods of fiscal 2016 were 22% and 30%, respectively.

Net income for the three and nine months ended December 31, 2016 was $1,840 and $3,222, respectively, compared with $1,274 and $5,611, respectively, for the same periods in the prior fiscal year. Income per diluted share in fiscal 2017 was $0.19 and $0.33 for the three and nine-month periods, compared with $0.13 and $0.56 for the same three and nine-month periods of fiscal 2016. Excluding the restructuring charge taken in the second quarter of fiscal 2017, net income for the nine months ended December 31, 2016 was $3,663, respectively, and income per diluted share was $0.38.

Liquidity and Capital Resources

The following discussion should be read in conjunction with our Condensed Consolidated Statements of Cash Flows:

	December 31, 2016	March 31, 2016
Cash and investments	$ 72,677	$65,072
Working capital	77,705	74,807
Working capital ratio[1]	3.5	3.7
Working capital excluding cash and investments	5,028	9,735

[1] Working capital ratio equals current assets divided by current liabilities.

Net cash generated by operating activities for the first nine months of fiscal 2017 was $10,707, compared with $22,171 for the first nine months of fiscal 2016. The decrease in cash generation year over year was attributable to lower net income and lower benefit from unbilled revenue and higher accounts receivable, partially offset by an increase in customer deposits and accrued compensation and income taxes payable.

Dividend payments and capital expenditures in the first nine months of fiscal 2017 were $2,616 and $241, respectively, compared with $2,415 and $883, respectively, for the first nine months of fiscal 2016. The higher dividend payment was due to the increase in dividends per share announced in January 2016.

Capital expenditures for fiscal 2017 are expected to be approximately $500. Approximately 85% of our fiscal 2017 capital expenditures are expected to be for productivity-enhancing machinery and equipment, with the remaining amounts expected to be used for information technology upgrades and other items.

Cash and investments were $72,677 on December 31, 2016 compared with $65,072 on March 31, 2016, up $7,605.

We invest net cash generated from operations in excess of cash held for near-term needs in short-term, less than 365 days, certificates of deposit, money market accounts or U.S. government instruments, generally with maturity periods of up to 180 days. Our money market account is used to securitize our outstanding letters of credit, which reduces our cost on those letters of credit. Approximately 95% of our cash and investments are held in the U.S. The remaining 5% is invested in our China operations.

Our revolving credit facility with JP Morgan Chase provides us with a line of credit of $25,000, including letters of credit and bank guarantees. In addition, our JP Morgan Chase agreement allows us to increase the line of credit, at our discretion, up to another $25,000, for total availability of $50,000. Borrowings under this credit facility are secured by all of our assets. We also have a $5,000 unsecured line of credit with HSBC, N.A. Letters of credit outstanding on December 31, 2016 and March 31, 2016 were $9,984 and $11,982, respectively. The outstanding letters of credit as of December 31, 2016 were issued by JP Morgan Chase, HSBC, as well as Bank of America (under our previous credit facility). There were no other amounts outstanding on our credit facilities at December 31, 2016 and March 31, 2016. The borrowing rate under our JP Morgan Chase facility as of December 31, 2016 was the bank's prime rate, or 3.75%. Availability under the JP Morgan Chase and HSBC lines of credit was $25,381 and $26,330 at December 31, 2016 and March 31, 2016, respectively. We believe that cash generated from operations, combined with our investments and available financing capacity under our credit facility, will be adequate both to meet our cash needs for the immediate future and to support our growth strategies.

Orders and Backlog

Orders for the three-month period ended December 31, 2016 were $17,699 compared with $22,263 for the same period in the prior year, a decrease of 21%. Orders represent written communications received from customers requesting us to supply products and/or services. Domestic orders were 59% of total orders, or $10,396, and international orders were 41% of total orders, or $7,303, in the current quarter compared with the third quarter of fiscal 2016, when domestic orders were 42%, or $9,442, of total orders, and international orders were 58%, or $12,821, of total orders.

During the first nine months of fiscal 2017, orders were $57,123, compared with $66,840 for the same period of fiscal 2016, a decrease of 15%. For the first nine months of fiscal 2017, power orders decreased by $9,713, refining by $7,424 and chemical and petrochemical by $4,765. These decreases were partially offset by orders in other commercial and industrial applications, including the U.S. Navy which increased by $12,185. See “Current Market Conditions” for additional information.

Backlog was $99,104 at December 31, 2016, compared with $104,015 at September 30, 2016, a 5% decrease, and down 8% from $107,963 at March 31, 2016. Backlog is defined as the total dollar value of orders received for which revenue has not yet been recognized. Approximately 50% to 55% of orders currently in our backlog are expected to be converted to sales within one year, 5% to 10% are expected to ship between 12 and 24 months, and 35% to 40% beyond two years. The majority of the orders that are expected to convert beyond twelve months are for the U.S. Navy. At December 31, 2016, 17% of our backlog was attributable to equipment for refinery project work, 14% for chemical and petrochemical projects, 9% for power projects, including nuclear, 57% for U.S. Navy projects and 3% for other industrial applications. At December 31, 2015, 24% of our backlog was attributed to equipment for refinery project work, 13% for chemical and petrochemical projects, 15% for power projects, 44% for U.S. Navy projects and 4% for other industrial applications. In the third quarter of fiscal 2017, an order for $399 which had been on hold, was moved into active status. At December 31, 2016, we had two projects for an aggregate of $6,461 on hold.

Strategy and Outlook

Ongoing weakness in the global energy markets is expected to continue to impact our business for the remainder of fiscal 2017. The decrease in requests for quotations and orders, as well as a number of cancellations which occurred in fiscal 2016 are resulting in a challenging fiscal 2017. Our pipeline has contracted over the past year as our oil refining and chemical market customers have further reduced their capital spending plans. We believe that the reduction in quoting activity from our customers is in reaction to continued low and volatile oil prices. The expected duration of this downturn is uncertain.

Despite the current downturn, we believe in the long-term potential of the energy and petrochemical markets we serve. Coupled with our diversification strategy for the U.S. Navy and the power market, we believe this long-term strength will support our strategy to significantly grow our business. We have invested in capacity to serve our commercial customers as well as to expand the work we do for the U.S. Navy. We continue to look for organic growth opportunities as well as acquisitions or other business combinations that we believe will allow us to expand our presence in both our existing and ancillary markets. We are focused on reducing earnings volatility, growing our business and diversifying our business and product lines.

We expect revenue in fiscal 2017 to be between $88,000 and $92,000. We project that 50% to 55% of our December 31, 2016 backlog will convert to sales over the next twelve months. The backlog that is expected to convert beyond twelve months includes a combination of U.S. Navy orders that have a long conversion cycle (up to five years) as well as certain commercial orders, the conversion of which has been extended by our customers.

We expect gross profit margin in fiscal 2017 to be in the 21% to 23% range. We believe that production overhead absorption will continue to be weak, which in turn puts pressure on our gross profit margins.

SG&A spending during fiscal 2017 is expected to be between $15,000 and $15,500, inclusive of the $630 restructuring charge which occurred in the first and second quarters, or approximately 16% and 18% of sales. Our effective tax rate during fiscal 2017 is expected to be between 28% and 30%.

Cash flow in fiscal 2017 will be much more moderate than fiscal 2016. In the first nine months of fiscal 2017 cash flow has been strong due to an influx of customer deposits which are expected to unwind over the next couple of quarters. Fiscal 2016 cash flow benefited from a build-up of accounts receivable and unbilled revenue which occurred in the latter portion of fiscal 2015 and that was converted to cash in fiscal 2016.

We continue to believe in the long-term outlook for the energy and petrochemical markets. We plan to continue to look toward future growth while being mindful of near term profitability, given short-term challenges.

Contingencies and Commitments

We have been named as a defendant in lawsuits alleging personal injury from exposure to asbestos allegedly contained in or accompanying our products. We are a co-defendant with numerous other defendants in these lawsuits and intend to vigorously defend ourselves against these claims. The claims in our current lawsuits are similar to those made in previous asbestos lawsuits that named us as a defendant. Such previous lawsuits either were dismissed when it was shown that we had not supplied products to the plaintiffs' places of work or were settled by us for immaterial amounts.

As of December 31, 2016, we are subject to the claims noted above, as well as other legal proceedings and potential claims that have arisen in the ordinary course of business. Although the outcome of the lawsuits, legal proceedings or potential claims to which we are or may become a party cannot be determined and an estimate of the reasonably possible loss or range of loss cannot be made, we do not believe that the outcomes, either individually or in the aggregate, will have a material effect on our results of operations, financial position or cash flows.

Critical Accounting Policies, Estimates, and Judgments

Our unaudited condensed consolidated financial statements are based on the selection of accounting policies and the application of significant accounting estimates, some of which require management to make significant assumptions. We believe that the most critical accounting estimates used in the preparation of our condensed consolidated financial statements relate to labor hour estimates and establishment of operational milestones which are used to recognize revenue under the percentage-of-completion method, fair value estimates of identifiable tangible and intangible assets acquired in business combinations, accounting for contingencies, under which we accrue a loss when it is probable that a liability has been incurred and the amount can be reasonably estimated, and accounting for pensions and other postretirement benefits. For further information, refer to Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations" and Item 8 "Financial Statements and Supplementary Data" included in our Annual Report on Form 10-K for the year ended March 31, 2016.

Off Balance Sheet Arrangements

We did not have any off balance sheet arrangements as of December 31, 2016 or March 31, 2016, other than operating leases and letters of credit.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The principal market risks (i.e., the risk of loss arising from market changes) to which we are exposed are foreign currency exchange rates, price risk and project cancellation risk.

The assumptions applied in preparing the following qualitative and quantitative disclosures regarding foreign currency exchange rate, price risk and project cancellation risk are based upon volatility ranges experienced by us in relevant historical periods, our current knowledge of the marketplace, and our judgment of the probability of future volatility based upon the historical trends and economic conditions of the markets in which we operate.

Foreign Currency

International consolidated sales for the three months and nine months ended December 31, 2016 were 23% and 26%, respectively, of total sales compared with 38% and 35%, respectively, for the same period of fiscal 2016. Operating in markets throughout the world exposes us to movements in currency exchange rates. Currency movements can affect sales in several ways, the foremost being our ability to compete for orders against foreign competitors that base their prices on relatively weaker currencies. Business lost due to competition for orders against competitors using a relatively weaker currency cannot be quantified. In addition, cash can be adversely impacted by the conversion of sales made by us in a foreign currency to U.S. dollars. In the first three and nine months of fiscal 2017, sales in foreign currencies represented 0% and 2%, respectively, of total sales by us and our wholly-owned subsidiaries. In the first three and nine months of fiscal 2016, all sales by us and our wholly-owned subsidiaries, for which we were paid, were denominated in the local currency of the respective subsidiary (U.S. dollars or Chinese RMB).

We have limited exposure to foreign currency purchases. In the first three and nine months of fiscal 2017, our purchases in foreign currencies represented 2% and 3% of cost of products sold, respectively. In the first three and nine months of 2016, our purchases in foreign currencies represented less than 1% of cost of products sold. At certain times, we may enter into forward foreign currency exchange agreements to hedge our exposure against potential unfavorable changes in foreign currency values on significant sales and purchase contracts negotiated in foreign currencies. Forward foreign currency exchange contracts were not used in the periods being reported on in this Quarterly Report on Form 10-Q and as of December 31, 2016 and March 31, 2016, we held no forward foreign currency contracts.

Price Risk

Operating in a global marketplace requires us to compete with other global manufacturers which, in some instances, benefit from lower production costs and more favorable economic conditions. Although we believe that our customers differentiate our products on the basis of our manufacturing quality and engineering experience and excellence, among other things, such lower production costs and more favorable economic conditions mean that certain of our competitors are able to offer products similar to ours at lower prices. In market downturns, such as we are currently experiencing, we typically see depressed price levels. Moreover, the cost of metals and other materials used in our products have experienced significant volatility. Such factors, in addition to the global effects of the ongoing volatility and disruption of the capital and credit markets, have resulted in downward demand and pricing pressure on our products.

Project Cancellation and Project Continuation Risk

Open orders are reviewed continuously through communications with customers. If it becomes evident to us that a project is delayed well beyond its original shipment date, management will move the project into "placed on hold" (i.e., suspended) category. Furthermore, if a project is cancelled by our customer, it is removed from our backlog. We attempt to mitigate the risk of cancellation by structuring contracts with our customers to maximize the likelihood that progress payments made to us for individual projects cover the costs we have incurred. As a result, we do not believe we have a significant cash exposure to projects which may be cancelled. In the third quarter of fiscal 2017, an order for $399 which had been on hold, was moved into active status. At December 31, 2016, we had two projects for an aggregate of $6,461 on hold.

Item 4.Controls and Procedures

Conclusion regarding the effectiveness of disclosure controls and procedures

Our President and Chief Executive Officer (principal executive officer) and Vice President-Finance & Administration and Chief Financial Officer (principal financial officer) each have evaluated the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on such evaluation, and as of such date, our President and Chief Executive Officer and Vice President-Finance & Administration and Chief Financial Officer concluded that our disclosure controls and procedures were effective in all material respects.

Changes in internal control over financial reporting

There has been no change to our internal control over financial reporting during the quarter covered by this Quarterly Report on Form 10-Q that has materially affected, or that is reasonably likely to materially affect, our internal control over financial reporting.

GRAHAM CORPORATION AND SUBSIDIARIES

FORM 10-Q

DECEMBER 31, 2016

PART II - OTHER INFORMATION

Item 6. Exhibits

See index to exhibits on page 26 of this report.

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.

GRAHAM CORPORATION

By: /s/ Jeffrey Glajch
Jeffrey Glajch
Vice President-Finance & Administration and
Chief Financial Officer

Date: February 3, 2017

INDEX TO EXHIBITS

(31)	Rule 13a-14(a)/15d-14(a) Certifications	
+	31.1	Certification of Principal Executive Officer
+	31.2	Certification of Principal Financial Officer
(32)	Section 1350 Certification	
+	32.1	Section 1350 Certifications
(101)	Interactive Date File	
+	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

+	Exhibit filed with this report.