KEY TRONIC CORP
Form 10-Q
May 11, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE PERIOD ENDED APRIL 3, 2010**

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE PERIOD FROM ______ TO ______.**

Commission File Number 0-11559

KEY TRONIC CORPORATION

(Exact name of registrant as specified in its charter)

Washington	**91-0849125**
(State of Incorporation)	**(I.R.S. Employer Identification No.)**

N. 4424 Sullivan Road

Spokane Valley, Washington 99216

(509) 928-8000

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

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

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

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

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

As of May 10, 2010, 10,232,640 shares of common stock, no par value (the only class of common stock), were outstanding.

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* Items are not applicable

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PART I: FINANCIAL INFORMATION

Item 1: Financial Statements

KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Unaudited)

	April 3, 2010	June 27, 2009
	(in thousands)	
Assets		
Current assets:		
Cash and cash equivalents	$ 4,610	$ 729
Trade receivables, net allowance for doubtful accounts of $111 and $111	27,078	24,867
Inventories	36,002	32,291
Other	6,878	3,168
Total current assets	74,568	61,055
Property, plant and equipment - net	11,598	11,199
Other assets:		
Restricted cash		124
Deferred income tax asset	4,560	4,611
Other	903	766
Total other assets	5,463	5,501
Total assets	$ 91,629	$ 77,755
Liabilities and shareholders equity		
Current liabilities:		
Accounts payable	$ 26,663	$ 18,703
Accrued compensation and vacation	4,496	3,198
Current portion of other long-term obligations	187	359
Other	1,669	1,351
Total current liabilities	33,015	23,611
Long-term liabilities:		
Revolving loan		2,412
Other long-term obligations	767	618
Total long-term liabilities	767	3,030
Total liabilities	33,782	26,641
Commitments and contingencies (Note 7)		
Shareholders equity:		
Common stock, no par value - shares authorized 25,000; issued and outstanding 10,168 and 10,066 shares, respectively	39,616	39,359
Retained earnings	17,222	10,843

Accumulated other comprehensive income	1,009	912
Total shareholders equity	57,847	51,114
Total liabilities and shareholders equity	$ 91,629	$ 77,755

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended	
	April 3, 2010	March 28, 2009
	(in thousands, except per share amounts)	
Net sales	$ 51,697	$ 44,233
Cost of sales	46,455	40,921
Gross profit on sales	5,242	3,312
Operating expenses:		
Research, development and engineering	796	533
Selling, general and administrative	2,216	2,340
Total operating expenses	3,012	2,873
Operating income	2,230	439
Interest expense	13	131
Income before income tax provision (benefit)	2,217	308
Income tax provision (benefit)	(2,197)	46
Net income	$ 4,414	$ 262
Earnings per share - basic	$ 0.44	$ 0.03
Weighted average shares outstanding - basic	10,126	10,066
Earnings per share - diluted	$ 0.43	$ 0.03
Weighted average shares outstanding - diluted	10,254	10,066

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Nine Months Ended	
	April 3, 2010	March 28, 2009
	(in thousands, except per share amounts)	
Net sales	$ 137,756	$ 139,460
Cost of sales	125,129	128,925
Gross profit on sales	12,627	10,535
Operating expenses:		
Research, development and engineering	2,063	1,751
Selling, general and administrative	6,225	6,533
Goodwill impairment		765
Total operating expenses	8,288	9,049
Operating income	4,339	1,486
Interest expense	77	493
Income before income tax provision (benefit)	4,262	993
Income tax provision (benefit)	(2,117)	217
Net income	$ 6,379	$ 776
Earnings per share - basic	$ 0.63	$ 0.08
Weighted average shares outstanding - basic	10,094	10,057
Earnings per share - diluted	$ 0.63	$ 0.08
Weighted average shares outstanding - diluted	10,148	10,075

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME

(Unaudited)

	Three Months Ended		Nine Months Ended	
	April 3, 2010	March 28, 2009	April 3, 2010	March 28, 2009
	(in thousands)		(in thousands)	
Net income	$ 4,414	$ 262	$ 6,379	$ 776
Other comprehensive (loss) income:				
Change in fair market value of foreign exchange contracts	692	(290)	857	(290)
Comprehensive income (loss), net	$ 5,106	$ (28)	$ 7,236	$ 486

Other comprehensive income for the three months and nine months ended April 3, 2010 are reflected net of tax $(497,000).

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Nine Months Ended	
	April 3, 2010	March 28, 2009
	(in thousands)	
Cash flows from operating activities:		
Net income	$ 6,379	$ 776
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization	1,156	1,145
Goodwill impairment		765
Provision for doubtful accounts		608
Provision for obsolete inventory	1,441	248
Provision for warranty	29	(96)
Loss on disposal of assets	3	
Deferred income taxes	(1,841)	
Changes in operating assets and liabilities:		
Trade receivables	(2,211)	6,829
Inventories	(5,152)	(677)
Other assets	(1,889)	411
Accounts payable	7,960	(8,436)
Accrued compensation and vacation	1,298	(1,676)
Other liabilities	475	211
Cash provided by operating activities	7,648	108
Cash flows from investing activities:		
Purchase of property and equipment	(1,542)	(256)
Proceeds from sale of property and equipment	7	
Cash used in investing activities	(1,535)	(256)
Cash flows from financing activities:		
Payment of financing costs	(50)	(50)
Repayment of long term debt	(151)	(211)
Decrease (increase) in restricted cash	124	(53)
Borrowings under revolving credit agreement	9,763	152,598
Repayment of revolving credit agreement	(12,175)	(154,063)
Proceeds from exercise of stock options	257	57
Cash used in financing activities	(2,232)	(1,722)
Net increase (decrease) in cash and cash equivalents	3,881	(1,870)
Cash and cash equivalents, beginning of period	729	2,879
Cash and cash equivalents, end of period	$ 4,610	$ 1,009
Supplemental cash flow information:		
Interest payments	$ 98	$ 509
Income tax payments, net of refunds	$ 173	$ 400

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. BASIS OF PRESENTATION

The condensed consolidated financial statements included herein have been prepared by Key Tronic Corporation and subsidiaries (the Company) pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). The financial statements reflect all normal and recurring adjustments which, in the opinion of management, are necessary for a fair presentation of the financial position, results of operations and cash flows for the interim periods presented. The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the reported amounts of revenues and expenses during the reporting period. Significant estimates include the allowance for doubtful receivables, the provision for obsolete and nonsaleable inventories, the valuation of deferred tax assets, impairment of long-lived assets, medical insurance liability, long-term incentive compensation accrual and the provision for warranty costs. Actual results could differ from those estimates. The results of operations for the periods presented are not necessarily indicative of the results to be expected for the full year. The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the financial statements and notes included in the Company s Annual Report on Form 10-K for the fiscal year ended June 27, 2009.

There were no significant events that occurred subsequent to the balance sheet date but prior to the filing of this report that would have a material impact on our Consolidated Financial Statements.

The Company s reporting period is a 52/53 week fiscal year ending on the Saturday closest to June 30. The quarter ended April 3, 2010 was a 14 week period, whereas the quarter ended March 28, 2009 was a 13 week period. Fiscal year 2010 will end on July 3, 2010 which is a 53 week year.

2. NEW ACCOUNTING PRONOUNCEMENTS

In June 2009, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 168, *The FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principles*. This statement establishes the FASB Accounting Standards Codification™ (ASC) as the single source of authoritative U.S. generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. This statement was codified into FASB ASC Topic 105, *Generally Accepted Accounting Principles*. The Codification structure was created to organize GAAP pronouncements using numerical designation by topic, subtopic, section, and paragraph so users can more easily access the authoritative accounting guidance. This guidance is effective for interim and annual periods ending after September 15, 2009. The Company adopted this statement in the first quarter of fiscal year 2010 and all SFAS references have been replaced with ASC references.

In August 2009, the FASB issued Accounting Standard Update (ASU) 2009-05, *Measuring Liabilities at Fair Value,* concerning measuring liabilities at fair value. The new guidance provides clarification that in circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure fair value using certain valuation techniques. Additionally, it clarifies that a reporting entity is not required to adjust the fair value of a liability for the existence of a restriction that prevents the transfer of the liability. This new guidance is effective for the first reporting period after its issuance, however earlier application is permitted. We have adopted the provisions of ASU 2009-05, which did not have a material impact on our consolidated financial statements.

In January 2010, the FASB issued ASU 2010-6, *Improving Disclosures About Fair Value Measurements*, which requires reporting entities to make new disclosures about recurring or nonrecurring fair-value measurements including significant transfers into and out of Level 1 and Level 2 fair-value measurements and information on purchases, sales, issuances, and settlements on a gross basis in the reconciliation of Level 3 fair-value measurements. ASU 2010-6 is effective for annual reporting periods beginning after December 15, 2009, except for Level 3 reconciliation disclosures which are effective for annual periods beginning after December 15, 2010. We do not expect the adoption of ASU 2010-6 to have a material impact on our consolidated financial statements.

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In February 2010, the FASB issued ASU 2010-09, *Subsequent Events Amendments to Certain Recognition and Disclosure Requirements* (ASU 2010-09), that amends ASC Subtopic 855-10, *Subsequent Events Overall* (ASC 855-10). ASU 2010-09 requires an SEC filer to evaluate subsequent events through the date that the financial statements are issued but removed the requirement to disclose this date in the notes to the entity s financial statements. The amendments are effective upon issuance of the final update and accordingly, we have adopted the provisions of ASU 2010-09. The adoption of this provision did not have a material impact on our consolidated financial statements.

3. INVENTORIES

The components of inventories consist of the following (in thousands):

	April 3, 2010	June 27, 2009
Finished goods	$ 4,538	$ 7,898
Work-in-process	4,715	3,968
Raw materials and supplies	26,749	20,425
	$ 36,002	$ 32,291

4. LONG-TERM DEBT

On August 19, 2009, the Company entered into a credit agreement with Wells Fargo Bank, N.A. providing for a revolving line of credit facility for up to $20 million and paid off the CIT Group/Business Credit, Inc. (CIT) revolving loan. The agreement specifies that the proceeds of the revolving line of credit be used primarily for working capital and general corporate purposes of the Company and its subsidiaries. Borrowings under this revolving line of credit bear interest at either a Base Rate or a Fixed Rate , as elected by the Company. The base rate is the higher of the JP Morgan Chase prime rate, daily one month London Interbank Offered Rate (LIBOR) plus 1.5%, or the Federal Funds rate plus 1.5% and the fixed rate is LIBOR plus 2.1% or LIBOR plus 2.5% depending on the level of trailing four quarters Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA).

The agreement is for a term of two years beginning on August 19, 2009 and ending on August 18, 2011. The Company must comply with certain financial covenants, including a cash flow leverage ratio and a trading ratio. The credit agreement requires the Company to maintain a minimum profit threshold, limits the maximum lease expenditures and restricts the Company from declaring or paying dividends in cash or stock.

The new line of credit is secured by substantially all of the assets of the Company. Based on the trailing four quarters EBITDA as of April 3, 2010, the Company could borrow up to $20.0 million under the Wells Fargo line of credit. There was no outstanding balance under the credit facility as of April 3, 2010. As of March 28, 2009, the range of interest being paid to CIT on outstanding balances was 2.85% to 3.25%.

5. INCOME TAXES

The Company had domestic income tax loss carryforwards of approximately $33.2 million at June 27, 2009. In accordance with FASB ASC Topic 740, *Income Taxes,* a valuation allowance is required if it is more likely than not that some or all of the deferred tax assets will not be realized in the future. In prior quarters, the Company had a valuation allowance on a portion of its deferred tax assets. However, based on sustained profitability, revenue growth, new customer programs and updated forecasting that occurred during the quarter, management determined during the third quarter of fiscal year 2010 that an allowance was no longer necessary on the domestic income tax loss carryforwards. This resulted in a non-cash deferred income tax benefit of approximately $6.6 million during the third quarter of fiscal 2010.

In addition to releasing the valuation allowance on its domestic income tax loss carryforwards, during the quarter the Company also reevaluated the potential future need to repatriate foreign earnings from its subsidiaries to fund domestic capital requirements and future acquisition opportunities. Therefore, during the quarter the Company also recorded a deferred tax liability for future anticipated repatriation of earnings. This resulted in a non-cash deferred income tax expense of approximately $4.1 million during the third quarter of fiscal 2010.

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The Company s judgments regarding deferred tax assets and liabilities may change due to changes in market conditions, changes in tax laws or other factors. If assumptions and estimates change in the future the valuation allowance will be adjusted accordingly in subsequent periods and any increase or decrease will result in an additional deferred income tax expense or benefit.

In addition to its domestic operations, the Company has subsidiaries in Mexico and China. The Company is currently applying certain tax credits to offset the income tax liabilities of its Mexican subsidiaries. As of January 1, 2008, the Company became subject to a Mexican business flat tax called Impuesto Empresarial a Tasa Unica (IETU). The effects of IETU and an associated presidential decree in fiscal year 2009 has been included in the effective tax rate. For the nine months ended April 3, 2010 and March 28, 2009 the tax was approximately $113,000 and $196,000, respectively. There was no tax expense in China due to income tax losses for the nine months ending April 3, 2010 and March 28, 2009. The income tax loss carryforwards in China have a 100% valuation allowance at April 3, 2010.

FASB ASC Topic 740, *Income Taxes,* requires the Company to recognize in its financial statements uncertainties in tax positions taken that may not be sustained upon examination by the taxing authorities. If interest or penalties are assessed, the Company would recognize these charges as income tax expense. The Company has not recorded any income tax expense or benefit for uncertain tax positions and does not anticipate any adjustments over the next 12 months.

6. EARNINGS PER SHARE

Basic earnings per share (EPS) is calculated by dividing net income (the numerator) by the weighted-average number of common shares outstanding (the denominator) during the period. Diluted EPS is computed by including both the weighted-average number of shares outstanding and any dilutive common share equivalents in the denominator. The following table presents a reconciliation of the denominator and the number of antidilutive common share options that were not included. These antidilutive securities occur when options outstanding have an option price greater than the average market price for the period:

	Three Months Ended (in thousands, except per share information)	
	April 3, 2010	**March 28, 2009**
Net income	$ 4,414	$ 262
Weighted average shares outstanding - basic	10,126	10,066
Effect of dilutive common stock options	128	
Weighted average shares outstanding - diluted	10,254	10,066
Earnings per share - basic	$ 0.44	$ 0.03
Earnings per share - diluted	$ 0.43	$ 0.03
Antidilutive options not included in diluted earnings per share	38,000	973,000

	Nine Months Ended (in thousands, except per share information)	
	April 3, 2010	**March 28, 2009**
Net income	$ 6,379	$ 776
Weighted average shares outstanding - basic	10,094	10,057
Effect of dilutive common stock options	54	18
Weighted average shares outstanding - diluted	10,148	10,075
Earnings per share - basic	$ 0.63	$ 0.08
Earnings per share - diluted	$ 0.63	$ 0.08

Antidilutive options not included in diluted earnings per share	180,000	930,000

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7. COMMITMENTS AND CONTINGENCIES

Purchase Commitments

The Company had no material firm commitments to contractors and suppliers for capital expenditures at April 3, 2010.

Leases

The Company leases certain facilities, equipment, and automobiles under non-cancelable lease agreements. These agreements expire on various dates over the next five years.

Warranties

The Company provides warranties on certain product sales. Allowances for estimated warranty costs are recorded during the period of sale. The determination of such allowances requires the Company to make estimates of product return rates and expected costs to repair or to replace the products under warranty. The Company currently establishes warranty reserves based on historical warranty costs for each product line combined with liability estimates based on the prior twelve months sales activities. If actual return rates and/or repair and replacement costs differ significantly from management s estimates, adjustments to recognize additional cost of sales may be required in future periods. The Company s warranty reserve was approximately $24,000 and $25,000 as of April 3, 2010 and June 27, 2009, respectively.

8. FAIR VALUE MEASUREMENTS

The Company has adopted the FASB ASC Topic 820*, Fair Value Measurements and Disclosures,* which defines fair value, establishes a framework for assets and liabilities being measured and reported at fair value and expands disclosures about fair value measurements. There are three levels of fair value hierarchy inputs used to value assets and liabilities which include: Level 1 inputs are quoted market prices for identical assets or liabilities; Level 2 inputs other than quoted market prices included in Level 1 that are observable for the asset or liability, either directly or indirectly; and Level 3 inputs are unobservable inputs for the asset or liability.

The following tables summarize the Company s financial assets and liabilities measured at fair value on a recurring basis as of April 3, 2010 and June 27, 2009 (in thousands):

	April 3, 2010				
	Level 1	Level 2	Level 3	Netting Adjustment(1)	Total Fair Value
Financial Assets:					
Foreign currency forward contracts	$	$ 1,506	$	$	$ 1,506

(1) This amount represents the impact of a legally enforceable payment netting agreement that allows the Company to settle positive and negative positions with the same counterparty.

	June 27, 2009				
	Level 1	Level 2	Level 3	Netting Adjustment(1)	Total Fair Value
Financial Assets:					
Foreign currency forward contracts	$	$ 912	$	$	$ 912

(1) This amount represents the impact of a legally enforceable payment netting agreement that allows the Company to settle positive and negative positions with the same counterparty.

The Company currently has forward contracts to hedge known future cash outflows for expenses denominated in the Mexican peso. These contracts are measured on a recurring basis based on the foreign currency spot rates and forward rates quoted by banks or foreign currency dealers. These contracts are marked to market using level 2 input criteria every period with the unrealized gain or loss, net of tax, reported as a component of shareholders equity in accumulated other comprehensive income, as they qualify for hedge accounting.

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The carrying values of the remaining financial instruments reflected on the balance sheet as of April 3, 2010 and June 27, 2009, reasonably approximate their fair value. Based on the borrowing rates currently available to the Company for loans with similar terms and average maturities, the fair value of long-term debt as of June 27, 2009 approximates the carrying value.

9. DERIVATIVE FINANCIAL INSTRUMENTS

In accordance with FASB ASC Topic 815*, Derivatives and Hedging, the* Company has expanded the quarterly and annual disclosures on its derivative instruments and hedging activities. The Company has entered into foreign currency forward contracts and those contracts are accounted for as cash flow hedges. The effective portion of the gain or loss on the derivative is reported as a component of accumulated other comprehensive income (AOCI) and is reclassified into earnings in the same period which the underlying hedged transaction affects earnings. The derivative s effectiveness represents the change in fair value of the hedge that offsets the change in fair value of the hedged item.

The Company transacts business in Mexico and is subject to the risk of foreign currency exchange rate fluctuations. The Company enters into foreign currency forward contracts to manage the foreign currency fluctuations for Mexican peso denominated payroll, utility, tax, and certain operating expenses. The foreign currency forward contracts have terms that are matched to the underlying transactions being hedged. As a result they are expected to fully offset the hedged risk and no ineffectiveness has been recorded.

As of April 3, 2010, the Company had outstanding foreign currency forward contracts of $18.8 million. These contract maturity dates do not exceed 18 months. As of April 3, 2010, the net amount of existing gains expected to be reclassified into earnings within the next 15 months was $1.5 million. During the three and nine months ended April 3, 2010, the Company entered into $0 and $14.6 million of foreign currency forward contracts and settled $4.7 million and $13.6 million of such contracts, respectively. Subsequent to April 3, 2010, the Company entered into an additional $16.2 of foreign currency forward contracts that extended the hedged position through June 27, 2012.

The Company does not enter into derivative instruments for trading or speculative purposes. The Company s counterparties to the foreign currency forward contracts are major banking institutions. These institutions do not require collateral for the contracts and the Company believes that the risk of the counterparties failing to meet their contractual obligations is remote.

The following table summarizes the fair value of derivative instruments in the Consolidated Balance Sheets as of April 3, 2010 and June 27, 2009 (in thousands):

Derivatives Designated as Hedging Instruments	Balance Sheet Location	April 3, 2010 Fair Value(1)	June 27, 2009 Fair Value(1)
Foreign currency forward contracts	Other current assets	$ 1,309	$ 912
Foreign currency forward contracts	Other long term assets	197	
Total		$ 1,506	$ 912

(1) Derivatives are carried at fair value in the consolidated balance sheets after reflecting the impact of legally enforceable payment netting agreements with the same counterparty. Refer to Note 8.

The following table summarizes the effect of derivative instruments on the Consolidated Financial Statements for the three months ended April 3, 2010 (in thousands):

Derivatives Designated as Hedging Instruments	AOCI Balance as of December 26, 2009	Effective Portion Recorded In AOCI	Effective (Gain) Reclassified From AOCI Into Cost of Sales	AOCI Balance as of April 3, 2010
Settled foreign currency forward contracts for the three months ended April 3, 2010	$ 342	$ 66	$ (408)	$

Unsettled foreign currency forward contracts		317		692				1,009
Total	$	659	$	758	$	(408)	$	1,009

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The following table summarizes the effect of derivative instruments on the Consolidated Financial Statements for the nine months ended April 3, 2010 (in thousands):

Derivatives Designated as Hedging Instruments	AOCI Balance as of June 27, 2009	Effective Portion Recorded In AOCI	Effective (Gain) Reclassified From AOCI Into Cost of Sales	AOCI Balance as of April 3, 2010
Settled foreign currency forward contracts for the nine months ended April 3, 2010	$ 760	$ 550	$ (1,310)	$
Unsettled foreign currency forward contracts	152	857		1,009
Total	$ 912	$ 1,407	$ (1,310)	$ 1,009

As of April 3, 2010, the Company does not have any foreign exchange contracts with credit-risk-related contingent features.

10. GOODWILL

In accordance with FASB ASC Topic 350, *Intangibles Goodwill and Other*, the Company recorded goodwill in the amount of $765,000, in fiscal year 1994 relating to the acquisition of Honeywell s manufacturing facilities in Juarez, Mexico. In accordance with FASB ASC Topic 350, goodwill is not amortized, but must be analyzed for impairment at least annually.

On December 27, 2008, the Company completed its annual impairment test. The Company performed the first step of its goodwill impairment test and determined that the book value of the Company exceeded its fair value based on the quoted market price of the Company s stock as of December 26, 2008. The result of the first step indicated that goodwill was impaired and therefore, the Company performed the second step of the goodwill analysis in accordance with FASB ASC Topic 350. The second step analyzes any excess or implied fair value of goodwill upon allocating the fair value of the Company to all its assets and liabilities other than goodwill and then comparing the residual amount, if any, to the book value of the goodwill. There was no residual amount of goodwill to allocate upon completing this step. As the deteriorating global macroeconomic environment adversely affected the Company s common stock price, the Company concluded that 100% of the goodwill was impaired due to the significant and sustained decline in the Company s market capitalization to below the book value. The Company recorded an impairment charge of $765,000 for the quarter ended December 27, 2008. As of April 3, 2010, there was no goodwill recorded in the Company s Consolidated Balance Sheet.

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations
FORWARD-LOOKING STATEMENTS

References in this report to the Company , Key Tronic , we , our , or us mean Key Tronic Corporation together with its subsidiaries, except where the context otherwise requires.

This Quarterly Report contains forward-looking statements in addition to historical information. Forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those reflected in the forward-looking statements. Risks and uncertainties that might cause such differences include, but are not limited to those outlined in Management s Discussion and Analysis of Financial Condition and Results of Operations Risks and Uncertainties that May Affect Future Results. Readers are cautioned not to place undue reliance on forward-looking statements, which reflect management s opinions only as of the date hereof. The Company undertakes no obligation to update forward-looking statements to reflect developments or information obtained after the date hereof and disclaims any obligation to do so. Readers should carefully review the risk factors described in periodic reports the Company files from time to time with the Securities and Exchange Commission, including Year-end Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K.

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OVERVIEW

Key Tronic Corporation (dba: KeyTronicEMS Co.), trading on the NASDAQ with the symbol KTCC, was organized in 1969 as a Washington corporation that locally manufactured computer keyboards. Our goal was to become the world s largest manufacturer of input devices for terminals, word processors and personal computers. The ability to design, build and deliver a quality product led to a reputation in the industry, allowing us to be a leading independent manufacturer of keyboards for computers in the United States. Our fully integrated design, tooling, and automated manufacturing capabilities enabled us to rapidly respond to customers needs for keyboards in production quantities worldwide. We supported our sales growth through the development and purchase of international manufacturing facilities. As the computer keyboard market matured with increasing competition from other international providers, we determined that our business could no longer solely rely on keyboard sales.

After assessing market conditions and our strengths and capabilities in 1999, we shifted focus from keyboard manufacturing to contract manufacturing for a wide range of products. Our new strategy was based on our original core strengths of innovative design and engineering expertise in electronics, mechanical engineering, and precision plastics combined with high-quality, low cost production, and assembly on a global basis. These strengths have made our company a strong competitor in the electronic manufacturing services (EMS) market. As we fully transitioned into an EMS provider, our new customer base became comprised of world-class customers from a wide range of industries.

The expansion of the EMS industry allowed us to continue to expand our customer base and the industries that we serve. The recent challenging global macroeconomic environment has, however, had a negative impact on our results of operations as the demand from our customers has declined. We successfully confronted the challenging global macroeconomic environment by reducing our costs while ramping up new customer programs, which allowed us to maintain profitability and strengthen our balance sheet. The ramp up for our new programs was slowed by the recession, but these new programs continue to represent a growing portion of our revenue and a promising foundation for our future. In keeping with our long-term strategic objectives, we have been successfully building a more diversified customer portfolio and a less concentrated revenue base, spanning a wider range of industries. We currently offer our customers the following services: integrated electronic and mechanical engineering, precision plastic molding, assembly, component selection, sourcing and procurement, worldwide logistics, and new product testing and production all at competitive pricing due to our global footprint.

We believe that we are well positioned in the EMS industry to continue the expansion of our customer base and achieve long term growth. Our core strengths continue to support our growth and our customers needs. We continue to focus on controlling operating expenses and leveraging the synergistic capabilities of our world-class facilities in the United States, Mexico, and China. This global production capability provides our customers with the benefits of improved supply-chain management, reduced inventory, lower labor costs, lower transportation costs, and reduced product fulfillment time. Given our competitive advantages and the growing need for some potential customers to move forward with their outsourcing strategies, we are strongly positioned to win new business in coming periods and grow our revenue and profits as the global macroeconomic environment improves.

The EMS industry is intensely competitive. We have less than 1% of the potential global market and our revenue can fluctuate significantly due to reliance on a concentrated base of customers. We are planning for new customer growth in the coming quarters by securing new programs, increasing our worldwide manufacturing capacity, and continuing to improve our manufacturing processes. Ongoing challenges that we face include the following: continuing to win programs from new and existing customers, balancing production capacity and key personnel in each of our manufacturing locations, improving operating efficiencies, controlling costs while developing competitive pricing strategies, successfully transitioning new program wins to full production and successfully addressing industry-wide shortages in the global supply chain.

Sales for the third quarter of fiscal year 2010 increased 16.9% to $51.7 million compared to $44.2 million for the same period of fiscal year 2009. This increase in sales was primarily driven by increased demand from both longstanding and new customers, partially offset by an unfavorable macroeconomic environment and industry-wide shortages in the global supply chain. Sales for the first nine months of fiscal 2010 were $137.8 million or a decrease of 1.2% from $139.5 million during the same period of the prior fiscal year. This decrease in sales for the first nine months of fiscal 2010 is primarily related to decreased demand from our customers as a result of an unfavorable macroeconomic environment during the first half of fiscal 2010 and industry-wide shortages in the global supply chain during the third quarter, partially offset by the increased revenue during the third quarter.

In the third quarter of fiscal 2010, we continued to successfully meet the challenges of the global macroeconomic environment by reducing our costs while ramping up our new customer programs and further diversifying our customer portfolio across a wide range of industries. Despite the macroeconomic uncertainty, we remain strongly positioned to win new business and currently expect to see sequential growth in the fourth quarter, driven by increased production levels of our new programs for both new and longstanding customers. Sales in the fourth quarter of fiscal year 2010 are expected to be in the range of $52 million to $58 million. Future results will depend on actual levels of customers orders, the timing of the start up of production of new product programs and industry-wide shortages in the global supply chain. We believe that we are well positioned in the EMS industry to continue expansion of our customer base and continue long-term growth.

Net income for the third quarter of fiscal year 2010 was $4.4 million compared to $0.3 million for the third quarter of fiscal year 2009. The increase in net income for the third quarter of fiscal year 2010 as compared to the third quarter of fiscal year 2009 was primarily due to a $7.5 million increase in sales and an approximate 2.6% improvement in our gross margin. Also, our third quarter fiscal 2010 results included a net deferred tax benefit of $2.5 million, resulting from the reduction of our valuation allowance on deferred tax assets related to our net operating loss carryforwards. The results from the third quarter of fiscal 2009 included charges of approximately $0.5 million related to an increased reserve on a doubtful foreign receivable and approximately $0.2 million related to severance charges related to cost reduction efforts that did not occur in the third quarter of fiscal year 2010.

Net income for the first nine months of fiscal year 2010 was $6.4 million compared to $0.8 million for the first nine months of fiscal year 2009. The increase in net income for the first nine months of fiscal year 2010 as compared to the first nine months of fiscal year 2009 was primarily due to an approximate 1.6% improvement in our gross margin. Also, our first nine months fiscal 2010 results included a net deferred tax benefit of $2.5 million, resulting from the reduction of our valuation allowance on deferred tax assets related to our net operating loss carryforwards. The results from the first nine months of fiscal 2009 included charges of approximately $0.8 million related to goodwill impairment, $0.5 million related to increased reserve on a doubtful foreign receivable and approximately $0.2 million related to severance charges related to cost reduction efforts that did not occur during the nine months ended fiscal year 2010.

Gross profit as a percentage of sales for the third quarter of fiscal year 2010 was 10.1% compared to 7.5% for the third quarter of fiscal year 2009. Gross profit was 9.2% for the first nine months of fiscal 2010 compared to 7.6% for the first nine months of fiscal 2009. The increase in gross profit as a percentage of net sales was due to higher sales and lower payroll costs in 2010 resulting from workforce reductions as well as severance costs and foreign exchange losses incurred in 2009 that did not recur in 2010. The level of gross margin is impacted by facility utilization, product mix, foreign exchange rates, timing of the start up of new programs, and pricing within the electronics industry and material costs, which can fluctuate significantly from quarter to quarter.

Operating income as a percentage of sales for the third quarter of fiscal year 2010 was 4.3% compared to 1.0% for the third quarter of fiscal year 2009. The increase in operating income as a percentage of sales was due to higher sales and gross margin, combined with our continued success in controlling costs and improving efficiencies during the third quarter of fiscal year 2010. Operating income as a percentage of sales for the first nine months of fiscal year 2010 was 3.1% compared to 1.1% for the first nine months of fiscal year 2009. The increase in operating income as a percentage of sales was due to an improved gross margin, combined with our continued success in controlling costs and improving efficiencies during the first nine months of fiscal year 2010.

We maintain a strong balance sheet with a current ratio of 2.3 with no bank debt as of April 3, 2010. Total cash provided by operations was $7.6 million for the nine months ended April 3, 2010. We maintain sufficient liquidity for our expected future operations and had no borrowing on our $20.0 million credit facility with Wells Fargo Bank, N.A. all of which is available as of April 3, 2010. We believe our cash flow generated from operations, our borrowing capacity, and equipment leasing should provide adequate capital for planned growth over the long term.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Revenue Recognition

We recognize revenue when products are shipped and the sales revenue becomes realizable. FASB ASC Topic 605, *Revenue Recognition*, states that revenue generally is realized or realizable and earned when all of the following criteria are met:

- Persuasive evidence of an arrangement exists.

Delivery has occurred or services have been rendered.

The seller s price to the buyer is fixed or determinable.

Collectability is reasonably assured.

We believe that we meet the above criteria for the following reasons:

Customer purchase orders confirming the price, shipping terms, and payment terms are required prior to shipment. The terms of our sales are generally FOB shipping point, meaning that the customer takes ownership of the goods and assumes the risk of loss when the goods leave our premises.

The seller s price to the buyer is fixed or determinable as noted, we require a customer purchase order, which confirms the price, shipping and payment terms.

Collectability is reasonably assured the credit terms for customers are pre-established based on a review of the customers perceived ability to pay so that collection of the account can be reasonably assured.

Inactive, Obsolete, and Surplus Inventory Reserve

We reserve for inventories that we deem inactive, obsolete or surplus. This reserve is calculated based upon the demand for the products that we produce. Demand is determined by expected sales or customer forecasts. If expected sales do not materialize, then we would have inventory in excess of our reserves and would have to charge the excess against future earnings. In the case where we have purchased material based upon a customer s forecast, we are usually covered by lead-time assurance agreements with each customer. These contracts state that the financial liability for material purchased within agreed upon lead-time and based upon the customer s forecasts, lies with the customer. If we purchase material outside the lead-time assurance agreement and the customer s forecasts do not materialize or if we have no lead-time assurance agreement for a specific program, we would have the financial liability and may have to charge inactive, obsolete or surplus inventory against earnings.

Allowance for Doubtful Accounts

We value our accounts receivable net of an allowance for doubtful accounts of $111,000 at April 3, 2010 and June 27, 2009. This allowance is based on estimates of the portion of accounts receivable that may not be collected in the future. The estimates used are based primarily on specific identification of potentially uncollectible accounts. Such accounts are identified using publicly available information in conjunction with evaluations of current payment activity. However, if any of our customers were to develop unexpected and immediate financial problems that would prevent payment of open invoices, we could incur additional and possibly material expenses that would negatively impact earnings.

Accrued Warranty

An accrual is made for expected warranty costs, with the related expense recognized in cost of goods sold. We review the adequacy of this accrual quarterly based on historical analysis and anticipated product returns and rework costs. As we have made the transition from manufacturing primarily keyboards to primarily EMS products, our exposure to warranty claims has declined significantly. Our warranty period for keyboards is generally longer than that for EMS products. We only warrant materials and workmanship on EMS products, and we do not warrant design defects for EMS customers.

Income Taxes

The Company had domestic income tax loss carryforwards of approximately $33.2 million at June 27, 2009. In accordance with FASB ASC Topic 740, *Income Taxes,* a valuation allowance is required if it is more likely than not that some or all of the deferred tax assets will not be realized in the future. In prior quarters, the Company had a valuation allowance on a portion of its deferred tax assets. However, based on sustained profitability, revenue growth, new customer programs and updated forecasting that occurred during the quarter, management determined that during the third quarter of fiscal year 2010 an allowance was no longer necessary on the domestic income tax loss carryforwards. This resulted in a non-cash deferred income tax benefit of approximately $6.6 million during the third quarter of fiscal 2010.

In addition to releasing the valuation allowance on its domestic income tax loss carryforwards, the Company also reevaluated the potential future need to repatriate foreign earnings from its subsidiaries to fund domestic capital requirements and future acquisition opportunities. Therefore, the Company also recorded a deferred tax liability for future anticipated repatriation of earnings during the quarter. This resulted in a non-cash deferred income tax expense of approximately $4.1 million during the third quarter of fiscal 2010.

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The Company s judgments regarding deferred tax assets and liabilities may change due to changes in market conditions, changes in tax laws or other factors. If assumptions and estimates change in the future the valuation allowance will be adjusted accordingly and any increase or decrease will result in an additional deferred income tax expense or benefit in subsequent periods.

Derivatives

We adopted FASB ASC Topic 815, *Derivatives and Hedging,* as of March 28, 2009. All material derivative instruments are recorded on the balance sheet at their respective fair values. Generally, if a derivative instrument is specifically designated as a cash flow hedge, the change in the fair value of the derivative is recorded in other comprehensive income to the extent the derivative is effective, and recognized in the statement of operations when the hedged item affects earnings. As of April 3, 2010, we had forward contracts to hedge known future cash outflows for payroll, utility, tax, and accounts payable expenses denominated in the Mexican peso. As of April 3, 2010, the fair value of these contracts was an asset of $1.5 million, of which, $1.3 million was included in other current assets and $0.2 million was included in other long term assets and recorded as unrealized income, net of tax, in accumulated other comprehensive income.

Goodwill

In accordance with FASB ASC Topic 350, *Intangibles Goodwill and Other*, the Company recorded goodwill in the amount of $765,000, in fiscal year 1994 relating to the acquisition of Honeywell s manufacturing facilities in Juarez, Mexico. In accordance with FASB ASC Topic 350, goodwill is not amortized, but must be analyzed for impairment at least annually.

On December 27, 2008, the Company completed its annual impairment test. The Company performed the first step of its goodwill impairment test and determined that the book value of the Company exceeded its fair value based on the quoted market price of the Company s stock as of December 26, 2008. The result of the first step indicated that goodwill was impaired and therefore, the Company performed the second step of the goodwill analysis in accordance with FASB ASC Topic 350. The second step analyzes any excess or implied fair value of goodwill upon allocating the fair value of the Company to all its assets and liabilities other than goodwill and then comparing the residual amount, if any, to the book value of the goodwill. There was no residual amount of goodwill to allocate upon completing this step. As the deteriorating global economy adversely affected the Company s common stock price, the Company concluded that 100% of the goodwill was impaired due to the significant and sustained decline in the Company s market capitalization to below the book value. The Company recorded an impairment charge of $765,000 for the quarter ended December 27, 2008. As of April 3, 2010, there was no goodwill recorded in the Company s Consolidated Balance Sheet.

RESULTS OF OPERATIONS

The financial information and discussion below should be read in conjunction with the Consolidated Financial Statements and Notes. The following table presents the percentage relationship to net sales of certain items in the Consolidated Statements of Operations for the periods indicated.

	Three Months Ended		Nine Months Ended	
	April 3, 2010	March 28, 2009	April 3, 2010	March 28, 2009
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales	89.9	92.5	90.8	92.4
Gross profit	10.1	7.5	9.2	7.6
Operating expenses				
Research, development and engineering	1.5	1.2	1.5	1.3
Selling, general and administrative	4.3	5.3	4.5	4.7
Goodwill impairment	0.0	0.0	0.0	0.5
Operating income	4.3	1.0	3.2	1.1
Interest expense	0.0	0.3	0.1	0.4

Income before income taxes	4.3	0.7	3.1	0.7
Income tax (benefit) provision	(4.2)	0.1	(1.5)	0.1