KEY TRONIC CORP
Form 10-Q
May 08, 2013

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 MARCH 30, 2013
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 Regulations S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See 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 April 26, 2013, 10,488,856 shares of common stock, no par value (the only class of common stock), were outstanding.

KEY TRONIC CORPORATION
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* Items are not applicable

“We”, “us”, “our”, “Company”, “KeyTronicEMS” and “KeyTronic”, unless the context otherwise requires, means Key Tronic Corporation and its subsidiaries.

PART I: FINANCIAL INFORMATION
Item 1: Financial Statements
KEY TRONIC CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Unaudited, in thousands)

	March 30, 2013	June 30, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	$3,202	$502
Trade receivables, net	48,435	60,709
Inventories	47,743	58,439
Deferred income tax asset	891	5,201
Other	7,610	4,639
Total current assets	107,881	129,490
Property, plant and equipment—net	18,195	17,306
Other assets:		
Deferred income tax asset	4,270	2,703
Other	3,896	1,413
Total other assets	8,166	4,116
Total assets	$134,242	$150,912
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$27,284	$43,025
Accrued compensation and vacation	6,797	6,337
Current portion of other long-term obligations	762	729
Other	3,802	3,163
Total current liabilities	38,645	53,254
Long-term liabilities:		
Revolving loan	—	15,011
Deferred income tax liability	1,607	1,094
Other long-term obligations	956	2,945
Total long-term liabilities	2,563	19,050
Total liabilities	41,208	72,304
Commitments and contingencies (Note 7)		
Shareholders' equity:		
Common stock, no par value—shares authorized 25,000; issued and outstanding 10,489 and 10,481 shares, respectively	43,131	42,372
Retained earnings	47,081	36,895
Accumulated other comprehensive income (loss)	2,822	(659)
Total shareholders' equity	93,034	78,608
Total liabilities and shareholders' equity	$134,242	$150,912

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited, in thousands, except per share amounts)

	Three Months Ended		Nine Months Ended	
	March 30, 2013	March 31, 2012	March 30, 2013	March 31, 2012
Net sales	$84,343	$95,527	$276,418	$249,742
Cost of sales	76,483	86,803	249,587	229,145
Gross profit	7,860	8,724	26,831	20,597
Research, development and engineering expenses	1,329	1,153	3,804	3,266
Selling, general and administrative expenses	2,938	2,879	8,406	8,229
Total operating expenses	4,267	4,032	12,210	11,495
Operating income	3,593	4,692	14,621	9,102
Interest expense, net	38	130	246	357
Income before income taxes	3,555	4,562	14,375	8,745
Income tax provision	692	1,168	4,189	930
Net income	$2,863	$3,394	$10,186	$7,815
Net income per share — Basic	$0.27	$0.32	$0.97	$0.75
Weighted average shares outstanding — Basic	10,489	10,447	10,488	10,437
Net income per share — Diluted	$0.26	$0.32	$0.94	$0.74
Weighted average shares outstanding — Diluted	10,931	10,762	10,888	10,517

See accompanying notes to consolidated financial statements.

KEY TRONIC CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited, in thousands)

	Three Months Ended		Nine Months Ended	
	March 30, 2013	March 31, 2012	March 30, 2013	March 31, 2012
Comprehensive income:				
Net income	$2,863	$3,394	$10,186	$7,815
Other comprehensive income:				
Unrealized gain (loss) on foreign exchange contracts, net of tax	2,458	2,301	3,481	(1,790)
Comprehensive income	$5,321	$5,695	$13,667	$6,025

Other comprehensive income for the three months ended March 30, 2013 and March 31, 2012 is reflected net of tax of approximately $1.3 million and $1.2 million, respectively. Other comprehensive income for the nine months ended March 30, 2013 and March 31, 2012 is reflected net of tax of approximately $1.8 million and $(0.9) million, respectively.
See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited, in thousands)

	Nine Months Ended	
	March 30, 2013	March 31, 2012
Decrease in cash and cash equivalents:		
Cash flows from operating activities:		
Net income	$10,186	$7,815
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization	1,955	1,725
Excess tax benefit from exercise of stock options	(103)	—
Provision for obsolete inventory	422	692
Provision for warranty	16	60
Provision for (recovery of) doubtful accounts	62	(91)
Loss on disposal of fixed assets	27	5
Share-based compensation expense	647	461
Deferred income taxes	1,495	496
Changes in operating assets and liabilities:		
Trade receivables	12,212	(19,253)
Inventories	10,274	(13,031)
Other assets	(2,199)	(1,527)
Accounts payable	(15,741)	14,824
Accrued compensation and vacation	460	845
Other liabilities	1,127	66
Cash provided by (used in) operating activities	20,840	(6,913)
Cash flows from investing activities:		
Purchase of property and equipment	(2,768)	(3,627)
Proceeds from sale of fixed assets	—	9
Proceeds from life insurance	144	—
Cash used in investing activities	(2,624)	(3,618)
Cash flows from financing activities:		
Payment of financing costs	(75)	(75)
Principal payments on long term debt	(542)	(513)
Borrowings under revolving credit agreement	66,528	88,400
Repayment of revolving credit agreement	(81,539)	(78,172)
Excess tax benefit from exercise of stock options	103	—
Proceeds from exercise of stock options	9	147
Cash (used in) provided by financing activities	(15,516)	9,787
Net increase (decrease) in cash and cash equivalents	2,700	(744)
Cash and cash equivalents, beginning of period	502	1,232
Cash and cash equivalents, end of period	$3,202	$488
Supplemental cash flow information:		
Interest payments	$289	$299
Income tax payments, net of refunds	$1,781	$493

See accompanying notes to consolidated financial statements.

KEY TRONIC CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
(Unaudited, in thousands)

	Shares	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balances, June 30, 2012	10,481	$42,372	$36,895	$ (659)	$78,608
Net income	—	—	10,186	—	10,186
Unrealized gain on foreign exchange contracts, net	—	—	—	3,481	3,481
Exercise of stock options	8	9	—	—	9
Share-based compensation	—	647	—	—	647
Tax benefit from exercise of stock options	—	103	—	—	103
Balances, March 30, 2013	10,489	$43,131	$47,081	$ 2,822	$93,034

See accompanying notes to consolidated financial statements.

KEY TRONIC CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

The 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). Certain information and footnote disclosures normally included in our annual consolidated financial statements have been condensed or omitted. The year-end consolidated balance sheet information was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. 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. 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 30, 2012.

The Company’s reporting period is a 52/53 week fiscal year ending on the Saturday closest to June 30. The three and nine month periods ended March 30, 2013 and March 31, 2012 were 13 week and 39 week periods, respectively. Fiscal year 2013 will end on June 29, 2013 which is a 52 week year, and fiscal year 2012 which ended on June 30, 2012, was also a 52 week year.

2. Significant Accounting Policies

Income Taxes

We compute our interim income tax provision through the use of an estimated annual effective tax rate (ETR) applied to year-to-date operating results and specific events that are discretely recognized as they occur. In determining the estimated annual ETR, we analyze various factors, including projections of our annual earnings, taxing jurisdictions in which the earnings will be generated, the impact of state and local income taxes, our ability to use tax credits and net operating loss carryforwards, and available tax planning alternatives. Discrete items, including the effect of changes in tax laws, tax rates, and certain circumstances with respect to valuation allowances or other unusual or non-recurring tax adjustments, are reflected in the period in which they occur as an addition to, or reduction from, the income tax provision, rather than included in the estimated annual ETR. Refer to Note 5 for further discussions.

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the estimated future tax consequences and benefits attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis, as well as operating losses and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which temporary differences and carryforwards are expected to be recovered or settled. The effect on deferred tax assets and liabilities for a change in tax rates is recognized in the period that includes the enactment date. Valuation allowances are established when necessary to reduce deferred tax assets to the amount that is more likely than not to be realized.

We utilize a two-step approach to recognizing and measuring uncertain tax positions. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount which is more than 50% likely of being realized upon ultimate settlement. We consider many factors when evaluating and estimating our tax positions and tax benefits, which may require periodic adjustments based on new assessments and changes in estimates and which may not accurately forecast actual outcomes. Our policy is to recognize interest and penalties related to the underpayment of income taxes as a component of income tax expense. To date, we have not incurred charges for interest or penalties in relation to the underpayment of income taxes. The tax years 1997 through the present remain open to examination by the major U.S. taxing jurisdictions to which we are subject.

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Earnings Per Common Share

Basic earnings per common share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted earnings per common share is computed by dividing net income by the combination of other potentially dilutive weighted average common shares and the weighted average number of common shares outstanding during the period using the treasury stock method. The computation assumes the proceeds from the exercise of equity awards were used to repurchase common shares at the average market price during the period. The computation of diluted earnings per common share does not assume conversion, exercise, or contingent issuance of common stock equivalent shares that would have an anti-dilutive effect on earnings per share.

Share-based Compensation

The Company's incentive plan provides for equity and liability awards to employees and non-employee directors in the form of stock options, stock appreciation rights (SARs), restricted stock, restricted stock units, stock awards, stock units, performance shares, performance units, and other stock-based or cash-based awards. Compensation cost is recognized on a straight-line basis over the requisite employee service period, which is generally the vesting period, and is recorded as employee compensation expense in cost of goods sold and selling, general and administrative expenses. Share-based compensation is recognized only for those awards that are expected to vest, with forfeitures estimated at the date of grant based on historical experience and future expectations.

On July 27, 2011, the Company granted 184,666 SARs under the 2010 Incentive Plan to certain key employees and outside directors at a strike price of $4.40 and a grant date fair value of $2.20. On January 26, 2012, the Company granted 32,000 SARs under the 2010 Incentive Plan to certain key employees at a strike price of $6.30 and a grant date fair value of $3.08. On July 25, 2012, the Company granted 210,666 SARs under the 2010 Incentive Plan to certain key employees and outside directors at a strike price of $7.44 and a grant date fair value of $3.71.

In addition to service conditions, these SARs contain a performance condition. The additional performance condition is based upon the achievement of Return on Invested Capital (ROIC) goals relative to a peer group. All awards with performance conditions are measured over the vesting period and are charged to compensation expense over the requisite service period based on the number of shares expected to vest. The SARs cliff vest after a three-year period from date of grant and expire five years from date of grant.

The grant date fair value for the awards granted were estimated using the Black Scholes option valuation method with the following assumptions at each of the respective grant dates:

	July 25, 2012	January 26, 2012	July 27, 2011
Expected dividend yield	— %	— %	— %
Risk – free interest rate	0.46 %	0.52 %	1.16 %
Expected volatility	66.50 %	64.90 %	65.50 %
Expected life (in years)	4.00	4.00	4.00

Total share-based compensation expense recognized during the three and nine months ended March 30, 2013 and March 31, 2012 was as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	March 30, 2013	March 31, 2012	March 30, 2013	March 31, 2012
Stock Appreciation Rights	$222	$161	$647	$461

As of March 30, 2013, total unrecognized compensation expense related to unvested share-based compensation arrangements was approximately $0.8 million. This expense is expected to be recognized over a weighted average period of 1.95 years.

No options to purchase shares of common stock were exercised during the three months ended March 30, 2013. During the three months ended March 31, 2012, 6,667 shares of common stock were exercised with an immaterial amount of intrinsic value for each of the periods presented. Options to purchase 7,500 and 54,167 shares of common stock were exercised during the nine months ended March 30, 2013 and March 31, 2012, respectively, with an immaterial amount of intrinsic value for each of the periods presented.

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Recently Issued Accounting Standards

In December 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2011-11, Disclosures about Offsetting Assets and Liabilities. The amendments in this Update will enhance disclosures required by U.S. generally accepted accounting principles (GAAP) by requiring improved information about financial instruments and derivative instruments that are either (1) offset in accordance with Accounting Standards Codification (ASC) 210-20-45 or ASC 815-10-45 or (2) subject to an enforceable master netting arrangement or similar agreement. The amendments are effective for fiscal years beginning on or after January 1, 2013 and for interim periods within those fiscal years. The amendments of ASU 2011-11 are not expected to have a material impact on the Company's consolidated financial statements.

In January 2013, the FASB issued Accounting Standards Update 2013-01, Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities. The main objective in developing this Update is to address implementation issues about the scope of Accounting Standards Update No. 2011-11, Balance Sheet Topic 210: Disclosures about Offsetting Assets and Liabilities. The amendments are effective for fiscal years beginning on or after January 1, 2013, and interim periods within those annual periods. The amendments of ASU 2013-01 are not expected to have a material impact on the Company's consolidated financial statements.

In February 2013, the FASB issued Accounting Standards Update 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. The objective of this Update is to improve the reporting of reclassifications out of accumulated other comprehensive income. The amendments in this Update seek to attain that objective by requiring an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under U.S. GAAP to be reclassified in its entirety to net income. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under U.S. GAAP that provide additional detail about those amounts. The amendments are effective prospectively for annual reporting periods beginning after December 15, 2012 and interim periods within those annual periods. The amendments of ASU 2013-02, when adopted, are not expected to have a material impact on the Company's consolidated financial statements, however will require additional disclosure within the notes to the financial statements.

Management has assessed the potential impact of other recently issued, but not yet effective, accounting standards and determined that the provisions are either not applicable to the Company, or are not anticipated to have a material impact on the consolidated financial statements.

3. Inventories

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

	March 30, 2013	June 30, 2012
Finished goods	$7,755	$9,805
Work-in-process	6,297	6,340
Raw materials and supplies	33,691	42,294
	$47,743	$58,439

4. Long-Term Debt

Note Payable – Bank

On October 15, 2010, the Company entered into an amended credit agreement with Wells Fargo Bank, N.A. thereby increasing its revolving line of credit facility for up to $30.0 million. On January 30, 2012, the Company entered into a second amendment to the credit agreement extending the term to October 15, 2016. 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 Wells Fargo Bank prime rate, daily one month London Interbank Offered Rate (LIBOR) plus 1.5%, or the Federal Funds rate plus 1.5%. The fixed rate is LIBOR plus 2.1% or LIBOR plus 2.5% depending on the level of the Company's trailing four quarters Earnings

Before Interest, Taxes, Depreciation and Amortization (EBITDA). The revolving line of credit is secured by substantially all of the assets of the Company.

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 operating lease expenditures and restricts the Company from declaring or paying dividends in cash or stock. The Company is in compliance with all financial covenants for all periods presented.

As of March 30, 2013, the Company had availability to borrow $30.0 million under the line of credit. The Company did not have an outstanding balance on the line of credit as of March 30, 2013. As of June 30, 2012, the outstanding balance under the credit facility was $15.0 million and the interest rate on the outstanding balance was in the range of 2.35% - 3.25%.

5. Income Taxes

The Company expects to repatriate a portion of its foreign earnings based on increased sales growth driving additional capital requirements domestically, cash requirements for potential acquisitions and to implement certain tax strategies. The Company currently expects to repatriate approximately $9.2 million of foreign earnings in the future. As such, these earnings would be recognized in the United States, and the Company would be subject to U.S. federal income taxes and potential withholding taxes in foreign jurisdictions. Both the domestic tax and estimated withholding tax of expected repatriation of foreign earnings have been recorded as part of deferred taxes as of March 30, 2013. All other unremitted foreign earnings are expected to remain permanently reinvested for planned fixed assets purchases in foreign locations.

The Company has available approximately $5.6 million of federal research and development tax credits as of March 30, 2013. ASC 740 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. Accordingly, as of March 30, 2013, the Company has recorded $3.0 million to date of unrecognized tax benefits associated with these federal tax credits, resulting in a net deferred tax benefit of approximately $2.6 million.

The Company has a wholly owned foreign subsidiary in Mexico that utilizes certain tax credits related to production assets that currently offset all of the income tax liabilities under general Mexican income tax law. However, the Company is subject to a Mexican business flat tax called Impuesto Empresarial a Tasa Unica (IETU). The Company anticipates that it will be taxable under IETU for the foreseeable future based on projected assets used in its operations. The effect of IETU and an associated presidential decree has been included in the effective tax rate for the nine months ended March 30, 2013.

The Company’s effective tax rate differs from the federal tax rate as follows (in thousands):

	Three Months Ended	
	March 30, 2013	March 31, 2012
Federal income tax provision at statutory rate	$1,209	$1,551
Foreign earnings taxed at lower rates	(194)	(83)
Effect of foreign currency rate changes	(40)	81
Recognition of tax credits, net	(490)	(191)
Change in valuation allowance	—	(445)
Other	207	255
Income tax provision	$692	$1,168

	Nine Months Ended	
	March 30, 2013	March 31, 2012
Federal income tax provision at statutory rate	$4,888	$2,973
Foreign earnings taxed at lower rates	(502)	(357)
Effect of foreign currency rate changes	(97)	(70)
Recognition of tax credits, net	(490)	(1,660)
Change in valuation allowance	—	(262)
Other	390	306
Income tax provision	$4,189	$930

On January 2, 2013, President Obama signed the American Taxpayer Relief Act (ATRA) of 2012 into law. As part of this legislation, the federal research and development (R&D) tax credit was retroactively reinstated for qualifying costs incurred from January 1, 2012 through December 31, 2013. Previously, the Company had only recognized tax benefits associated with credits generated through December 31, 2011.

Because ATRA was signed into law after the end of the Company's second quarter, the benefits associated with R&D tax credits generated from January 1, 2012 through March 30, 2013 were recognized during the third quarter of fiscal 2013, resulting in net tax benefit of approximately $490,000 after consideration of an increase in the allowance for uncertain tax positions related to these credits in the amount of $121,000.

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 awards that were not included in the diluted earnings per share calculation. These antidilutive securities occur when equity awards outstanding have an option price greater than the average market price for the period:

	Three Months Ended (in thousands, except per share information)	
	March 30, 2013	March 31, 2012
Net income	$ 2,863	$ 3,394
Weighted average shares outstanding—basic	10,489	10,447
Effect of dilutive common stock options	442	315
Weighted average shares outstanding—diluted	10,931	10,762
Earnings per share—basic	$ 0.27	$ 0.32
Earnings per share—diluted	$ 0.26	$ 0.32
Antidilutive options not included in diluted earnings per share	—	—

	Nine Months Ended (in thousands, except per share information)	
	March 30, 2013	March 31, 2012
Net income	$ 10,186	$ 7,815
Weighted average shares outstanding—basic	10,488	10,437
Effect of dilutive common stock options	400	80
Weighted average shares outstanding—diluted	10,888	10,517
Earnings per share—basic	$ 0.97	$ 0.75
Earnings per share—diluted	$ 0.94	$ 0.74
Antidilutive options not included in diluted earnings per share	—	554

7. Commitments and Contingencies

Purchase Commitments

The Company had no material firm commitments to contractors and suppliers for capital expenditures at March 30, 2013.

Leases

The Company leases certain facilities, equipment, and automobiles under non-cancelable lease agreements. These agreements expire on various dates over the next ten 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. 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 $9,400 and $23,000 as of March 30, 2013 and June 30, 2012, respectively.

8. Fair Value Measurements

The Company has adopted ASC 820, Fair Value Measurements, 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 table summarizes the fair values of assets/(liabilities) of the Company's derivatives that are required to be measured on a recurring basis as of March 30, 2013 and June 30, 2012 (in thousands):

	March 30, 2013			
	Level 1	Level 2	Level 3	Total Fair Value
Financial Assets:				
Foreign currency forward contracts	$—	$4,285	$—	$4,285
Financial Liabilities:				
Foreign currency forward contracts	$—	$(3)	$—	$(3)

	June 30, 2012			
	Level 1	Level 2	Level 3	Total Fair Value
Financial Assets:				
Foreign currency forward contracts	$—	$858	$—	$858
Financial Liabilities:				
Foreign currency forward contracts	$—	$(1,851)	$—	$(1,851)

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.

The carrying values of cash and cash equivalents, accounts receivable and current liabilities reflected on the balance sheets at March 30, 2013 and June 30, 2012, reasonably approximate their fair value.

9. Derivative Financial Instruments

The Company has entered into foreign currency forward contracts which are accounted for as cash flow hedges in accordance with ASC 815, Derivatives and Hedging. The effective portion of the gain or loss on the derivative is reported as a component of accumulated other comprehensive income and is reclassified into earnings in the same period in 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 other local expenses. The foreign currency forward contracts have terms that were effective to the underlying transactions being hedged.

As of March 30, 2013, the Company had outstanding foreign currency forward contracts with a total notional amount of $62.2 million. These contract maturity dates extend through March 2016. The Company entered into $10.9 million of foreign currency forward contracts and settled $5.8 million of foreign currency forward contracts during the three months ended March 30, 2013. For the three months ended March 31, 2012, the Company entered into foreign currency forward contracts of $5.0 million and settled $5.9 million of such contracts.

For the nine months ended March 30, 2013, the Company entered into forward contracts of $21.5 million and settled $17.0 million of such contracts. During the same period of the previous year, the Company entered into foreign currency forward contracts of $17.2 million and settled $14.1 million of such contracts.

The following table summarizes the fair value of derivative instruments in the Consolidated Balance Sheets as of March 30, 2013 and June 30, 2012 (in thousands):

		March 30, 2013		June 30, 2012	
Derivatives Designated as Hedging Instruments	Balance Sheet Location	Fair Value		Fair Value	
Foreign currency forward contracts	Other current assets	$953		$199	
Foreign currency forward contracts	Other long-term assets	$3,332		$659	
Foreign currency forward contracts	Other current liabilities	$(3	)	$(923	)
Foreign currency forward contracts	Other long-term liabilities	$—		$(928	)

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The following tables summarize the gain (loss) on derivative instruments, net of tax, on the Consolidated Statements of Income for the three months ended March 30, 2013 and March 31, 2012, respectively (in thousands):

Derivatives Designated as Hedging Instruments	AOCI Balance as of December 29, 2012	Effective Portion Recorded In AOCI	Effective Portion Reclassified From AOCI Into Cost of Sales	AOCI Balance as of March 30, 2013
Settled foreign currency forward contracts for the three months ended March 30, 2013	$(9)	$184	$ (175)	$—
Unsettled foreign currency forward contracts	373	2,449	—	2,822
Total	$364	$2,633	$ (175)	$2,822

Derivatives Designated as Hedging Instruments	AOCI Balance as of December 31, 2011	Effective Portion Recorded In AOCI	Effective Portion Reclassified From AOCI Into Cost of Sales	AOCI Balance as of March 31, 2012
Settled foreign currency forward contracts for the three months ended March 31, 2012	$(167)	$217	$ (50)	$—
Unsettled foreign currency forward contracts	(2,184)	2,134	—	(50)
Total	$(2,351)	$2,351	$ (50)	$(50)

The following tables summarize the gain (loss) on derivative instruments, net of tax, on the Consolidated Statements of Income for the nine months ended March 30, 2013 and March 31, 2012, respectively (in thousands):

Derivatives Designated as Hedging Instruments	AOCI Balance as of June 30, 2012	Effective Portion Recorded In AOCI	Effective Portion Reclassified From AOCI Into Cost of Sales	AOCI Balance as of March 30, 2013
Settled foreign currency forward contracts for the nine months ended March 30, 2013	$(162)	$675	$ (513)	$—
Unsettled foreign currency forward contracts	(497)	3,319	—	2,822
Total	$(659)	$3,994	$ (513)	$2,822

Derivatives Designated as Hedging Instruments	AOCI Balance as of July 2, 2011	Effective Portion Recorded In AOCI	Effective Portion Reclassified From AOCI Into Cost of Sales	AOCI Balance as of March 31, 2012
Settled foreign currency forward contracts for the nine months ended March 31, 2012	$800	$(684)	$ (116)	$—
Unsettled foreign currency forward contracts	940	(990)	—	(50)
Total	$1,740	$(1,674)	$ (116)	$(50)

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 financial 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. As of March 30, 2013, the net amount of unrealized gain expected to be reclassified into earnings within the next 12 months is approximately $0.6 million.

As of March 30, 2013, the Company does not have any foreign exchange contracts with credit-risk-related contingent features.

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", "KeyTronicEMS", "we", "our", or "us" mean Key Tronic Corporat 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.

Overview

KeyTronicEMS is a leader in electronic manufacturing services and solutions to original equipment manufacturers of a broad range of products. We provide engineering services, worldwide procurement and distribution, materials management, world-class manufacturing and assembly services, in-house testing, and expertise in providing customer service. Our international production capability provides our customers with benefits of improved supply-chain management, reduced inventories, lower transportation costs, and reduced product fulfillment time. We continue to make investments in all of our operating facilities to give us the production capacity and logistical advantages to continue to win new business. The following information should be read in conjunction with the consolidated financial statements included herein and with Part II Item 1A, Risk Factors included as part of this filling.

Our mission is to provide our customers with superior manufacturing and engineering services at the lowest total cost for the highest quality products, and create long-term mutually beneficial business relationships.

Executive Summary

After strong year-over-year growth in the first half of fiscal 2013, our revenue in the third quarter was primarily impacted by the anticipated and previously disclosed slowdown from the large customer that began to reduce production levels in the second quarter. Although we saw a continued ramp up of our new programs in the third quarter, those increases did not yet offset the decreased demand from this one customer. At the same time, we maintained strong operating efficiencies and further strengthened our balance sheet.

Net sales of $84.3 million for the third quarter of fiscal year 2013 decreased by 11.7 percent as compared to net sales of $95.5 million for the third quarter of fiscal year 2012. The decrease in net sales was primarily driven by the overall decrease in demand related to current customer programs, which includes the larger customer discussed above, the uncertain macroeconomic environment and program losses, and was partially offset by the positive impact of new customer programs. We believe that we are well positioned in the electronic manufacturing services (EMS) industry to win new business in coming periods and renew sequential revenue growth during the coming fiscal year.

The concentration of our top five customers' sales decreased to 62.4 percent of total sales in the third quarter of fiscal year 2013 from 72.6 percent in the same period of the prior fiscal year. Our current customer relationships involve a variety of products, including consumer electronics, electronic storage devices, plastics, household products, gaming devices, specialty printers, telecommunications, industrial equipment, military supplies, computer accessories, and electronic whiteboards. At the end of the third quarter of fiscal year 2013, we were generating revenue from 177 separate programs and 56 distinct customers as compared to 155 programs and 42 customers at the end of the third quarter of fiscal year 2012. We continue to see a robust pipeline of potential new business and have further diversified our future revenue base during the third quarter by winning new customer programs involving RFID, industrial power, LED lighting and commercial washroom equipment.

Sales to our largest customers may vary significantly from quarter to quarter depending on the size and timing of customer program commencement, forecasts, delays, and design modifications. We remain dependent on continued sales to our significant customers and most contracts with customers are not firm long-term purchase commitments.

We seek to maintain flexibility in production capacity by employing skilled temporary and short-term labor and by utilizing short-term leases on equipment and manufacturing facilities. In addition, our capacity and core competencies for printed circuit board assemblies (PCBAs), precision molding, tool making, assembly, and engineering can be applied to a wide variety of products.

Gross profit as a percent of sales was 9.3 percent for the third quarter of fiscal year 2013 as compared to 9.1 percent for the same quarter of the prior fiscal year. The increase in gross profit as a percentage of net sales was primarily due to a decrease in material-related costs as a percentage of net sales and a decrease in inventory provision, partially offset by an increase in certain overhead costs.

Operating income as a percentage of sales for the third quarter of fiscal year 2013 was 4.3 percent compared to 4.9 percent for the same quarter of the prior fiscal year. The decrease in operating income as a percentage of sales was primarily due to the slight increase in headcount to support recently won business and anticipated future growth.

Net income for the third quarter of fiscal year 2013 was $2.9 million or $0.26 per diluted share, as compared to $3.4 million or $0.32 per diluted share for the third quarter of fiscal year 2012. The decrease in net income for the third quarter of fiscal year 2013 as compared to the same period in fiscal year 2012, is the result of a decrease in net sales as discussed in further detail in the “Results of Operations” section.

We maintain a strong balance sheet with a current ratio of 2.8 and a long-term debt to equity ratio of 0.01 as of March 30, 2013. Total cash provided by operating activities as defined on our cash flow statement was $20.8 million for the nine months ended March 30, 2013. We maintain sufficient liquidity for our expected future operations. We did not have an outstanding balance on our revolving line of credit with Wells Fargo Bank, N.A. as of March 30, 2013. As a result, $30.0 million remained available to borrow as of March 30, 2013. We believe cash flow generated from operations, our borrowing capacity, and leasing opportunities should provide adequate capital for planned growth.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Preparation of our consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of contingent assets and liabilities. These estimates and assumptions are based on historical results as well as future expectations. Actual results could vary from our estimates and assumptions.

The accounting policies and estimates listed below are those that we believe are the most critical to our consolidated financial condition and results of operations. They are also the accounting policies that typically require our most difficult, subjective and complex judgments and estimates, often for matters that are inherently uncertain including.

- Inactive, Obsolete, and Surplus Inventory Reserve
- Allowance for Doubtful Accounts
- Accrued Warranty
- Income Taxes
- Share-Based Compensation
- Impairment of Long-Lived Assets
- Derivatives and Hedging Activity

Please refer to the discussion of critical accounting policies in our most recent Annual Report on Form 10-K for the fiscal year ended June 30, 2012, for further details.

RESULTS OF OPERATIONS
Comparison of the Three Months Ended March 30, 2013 with the Three Months Ended March 31, 2012
The financial information and discussion below should be read in conjunction with the Consolidated Financial Statements and Notes.
The following table sets forth certain information regarding the components of our consolidated statements of income for the three months ended March 30, 2013 as compared to the three months ended March 31, 2012. It is provided to assist in assessing differences in our overall performance (in thousands):

	Three Months Ended					
	March 30, 2013	% of net sales	March 31, 2012	% of net sales	$ change	% point change
Net sales	$84,343	100.0 %	$95,527	100.0 %	$(11,184)	— %
Cost of sales	76,483	90.7 %	86,803	90.9 %	(10,320)	(0.2)%
Gross profit	7,860	9.3 %	8,724	9.1 %	(864)	0.2 %
Research, development and engineering	1,329	1.6 %	1,153	1.2 %	176	0.4 %
Selling, general and administrative	2,938	3.5 %	2,879	3.0 %	59	0.5 %
Total operating expenses	4,267	5.1 %	4,032	4.2 %	235	0.9 %
Operating income	3,593	4.3 %	4,692	4.9 %	(1,099)	(0.6)%
Interest expense, net	38	— %	130	0.1 %	(92)	(0.1)%
Income before income taxes	3,555	4.2 %	4,562	4.8 %	(1,007)	(0.6)%
Income tax provision	692	0.8 %	1,168	1.2 %	(476)	(0.4)%
Net income	$2,863	3.4 %	$3,394	3.6 %	$(531)	(0.2)%
Effective income tax rate	19.5 %		25.6 %			

Net Sales
The decrease in net sales from the prior year period was primarily driven by an $11.8 million overall decrease in demand related to current customer programs, which includes the larger customer discussed previously, the uncertain macroeconomic environment and program losses of approximately $2.3 million. This was partially offset by an increase of approximately $2.9 million related to new customer programs.
During the three months ended March 30, 2013, we continued to ramp up our new customer programs and further diversified our customer portfolio across a wide range of industries. Despite the macroeconomic uncertainty, we remain strongly positioned to win new business and expect to see a modest growth in revenue during the remainder of the year, driven by increased production levels of new programs for both new and longstanding customers.
For the fourth quarter of fiscal year 2013, we expect to report revenue in the range of $83 million to $87 million. After strong year-over-year growth in the first half of fiscal 2013, our revenue in the third quarter was primarily impacted by the anticipated and previously disclosed slowdown from a significant customer that began to reduce production levels in the second quarter. Although we saw a continued ramp up of our new programs in the third quarter, those increases did not yet offset the decreased demand from this one customer. At the same time, we maintained strong operating efficiencies and further strengthened our balance sheet. While we expect our fourth quarter results to be similar to the third quarter, we currently anticipate renewed sequential growth during the coming fiscal year.
Future results will depend on actual levels of customers’ orders, the timing of the startup of production of new product programs and the impact of the 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.
Gross Profit
Gross profit as a percentage of sales for the three months ended March 30, 2013 was 9.3 percent compared to 9.1 percent for the three months ended March 31, 2012. This 0.2 percentage point increase is primarily related to a 2.5 percentage point decrease in material related costs as a percent of net sales, partially offset by a 2.3 percentage point increase of certain overhead costs. The level of gross margin is impacted by facility utilization, product mix, timing, severity and steepness of new program ramps, pricing within the electronics industry and material costs, which can

fluctuate significantly from quarter to quarter.

Included in gross profit are charges related to changes in the allowance for obsolete inventory. We recorded a provision of approximately $67,000 and $534,000 for obsolete inventory during the three months ended March 30, 2013 and March 31, 2012, respectively. We adjust the allowance for estimated obsolescence as necessary in an amount equal to the difference between the cost of inventory and estimated net realizable value based on assumptions as to future demand and market conditions. The reserves are established for inventory that we have determined customers are not contractually responsible for and for inventory that we believe customers will be unable to purchase.

Operating Expenses

Total research, development, and engineering (RD&E) expenses were $1.3 million and $1.2 million during the three months ended March 30, 2013 and March 31, 2012, respectively. Total RD&E expenses as a percent of net sales were 1.6 percent and 1.2 percent during the three months ended March 30, 2013 and March 31, 2012, respectively. This 0.4 percentage point increase in RD&E is primarily related to the decrease in net sales and a slight increase in headcount to support new programs and anticipated growth.

Total selling, general and administrative (SG&A) expenses were flat at $2.9 million during the three months ended March 30, 2013 and March 31, 2012. Total SG&A expenses as a percent of net sales were 3.5 percent during the three months ended March 30, 2013 compared to 3.0 percent during the three months ended March 31, 2012. This 0.5 percentage point increase in SG&A as a percentage of net sales is primarily related to the decrease in net sales, an increase in labor related expenses and to a lesser extent other overhead costs.

Total operating expenses were $4.3 million or 5.1 percent of net sales for the three months ended March 30, 2013 and $4.0 million or 4.2 percent of net sales for the three months ended March 31, 2012. The 0.9 percentage point increase in operating expenses as a percentage of net sales is primarily related to the decrease in net sales, an increase in labor related expenses and to a lesser extent other overhead costs.

Interest

Interest expense decreased to $38,000 during the three months ended March 30, 2013 from $130,000 during the three months ended March 31, 2012. This decrease is related to a decrease in the average balance outstanding on our line of credit.

Income Taxes

The effective tax rate for the three months ended March 30, 2013 was 19.5 percent compared to 25.6 percent for the three months ended March 31, 2012. The effective tax rate decreased from prior year primarily due to a discrete item recorded in the three months ended March 30, 2013 for certain R&D tax credits. For further information on the effective tax rate see footnote 5 of the “Notes to Consolidated Financial Statements”.

On January 2, 2013, the American Taxpayer Relief Act (ATRA) of 2012 was signed into law. As part of this legislation, the federal research and development (R&D) tax credit was retroactively reinstated for qualifying costs incurred from January 1, 2012 through December 31, 2013. Previously, we had only recognized tax benefits associated with credits generated through December 31, 2011. Due to the fact that ATRA was signed into law after the end of our second quarter, a net benefit of approximately $490,000 related to tax credits from January 1, 2012 through March 30, 2013 was recognized during the third quarter of fiscal 2013.

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

RESULTS OF OPERATIONS

Comparison of the Nine Months Ended March 30, 2013 with the Nine Months Ended March 31, 2012

The financial information and discussion below should be read in conjunction with the Consolidated Financial Statements and Notes.

The following table sets forth certain information regarding the components of our consolidated statements of income for the nine months ended March 30, 2013 as compared to the nine months ended March 31, 2012. It is provided to assist in assessing differences in our overall performance (in thousands):

	Nine Months Ended					
	March 30, 2013	% of net sales	March 31, 2012	% of net sales	$ change	% point change
Net sales	$276,418	100.0 %	$249,742	100.0 %	$26,676	— %
Cost of sales	249,587	90.3 %	229,145	91.8 %	20,442	(1.5)%
Gross profit	26,831	9.7 %	20,597	8.2 %	6,234	1.5 %
Research, development and engineering	3,804	1.4 %	3,266	1.3 %	538	0.1 %
Selling, general and administrative	8,406	3.0 %	8,229	3.3 %	177	(0.3)%
Total operating expenses	12,210	4.4 %	11,495	4.6 %	715	(0.2)%
Operating income	14,621	5.3 %	9,102	3.6 %	5,519	1.7 %
Interest expense, net	246	0.1 %	357	0.1 %	(111)	— %
Income before income taxes	14,375	5.2 %	8,745	3.5 %	5,630	1.7 %
Income tax provision	4,189	1.5 %	930	0.4 %	3,259	1.1 %
Net income	$10,186	3.7 %	$7,815	3.1 %	$2,371	0.6 %
Effective income tax rate	29.1 %		10.6 %			

Net Sales

The increase in net sales from prior year was primarily driven by an approximate $20.5 million overall increase related to increased demand from current customer programs, which was partially offset by the previously disclosed slowdown from the large customer that began to reduce production levels in the second quarter of fiscal year 2013. In addition, we experienced a $6.7 million increase in revenues related to new customer programs, partially offset by the negative impact of an uncertain macroeconomic environment and program losses of approximately $0.5 million. During the nine months ended March 30, 2013, we continued to ramp up our new customer programs and further diversified our customer portfolio across a wide range of industries. Despite the macroeconomic uncertainty, we remain strongly positioned to win new business and expect to see a modest growth in revenue during the remainder of the year, driven by increased production levels of new programs for both new and longstanding customers.

For the fourth quarter of fiscal year 2013, we expect to report revenue in the range of $83 million to $87 million. Our revenue is being reduced by the continued slowdown in demand from the same customer that began to reduce its production levels in the second quarter. In coming periods, however, we expect to see the continued ramp up of our new programs to more than offset this customer's decrease in demand. We continue to see a robust pipeline of potential new business and have further diversified our future revenue base during the third quarter by winning new customer programs involving RFID, industrial power, LED lighting and commercial washroom equipment. We believe this trend towards larger quote opportunities reflects increased recognition of the competitive advantages of North American based manufacturing for products sold in the Americas. Over the long term, we believe our unique combination of global logistics with world-class engineering and production capabilities in North America and China will continue to fuel our growth. Future results will depend on actual levels of customers' orders, the timing of the startup of production of new product programs and the impact of the 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.

Gross Profit

Gross profit as a percentage of sales for the nine months ended March 30, 2013 was 9.7 percent compared to 8.2 percent for the nine months ended March 31, 2012. This 1.5 percent point increase is primarily related to a 1.2 percentage point decrease in material cost as a percent of net sales and a 0.3 percentage point improvement in leveraging of certain overhead costs. The level of gross margin is impacted by facility utilization, product mix, timing, severity and steepness of new program ramps, pricing within the electronics industry and material costs, which can fluctuate significantly from quarter to quarter.

Included in gross profit are charges related to changes in the allowance for obsolete inventory. We recorded a provision of approximately $422,000 and $692,000 for obsolete inventory for the nine months ended March 30, 2013 and March 31, 2012, respectively. We adjust the allowance for estimated obsolescence as necessary in an amount equal to the difference between the cost of inventory and estimated net realizable value based on assumptions as to future demand and market conditions. The reserves are established for inventory that we have determined customers are not contractually responsible for and for inventory that we believe customers will be unable to purchase.

Operating Expenses

Total research, development, and engineering (RD&E) expenses were $3.8 million and $3.3 million during the nine months ended March 30, 2013 and March 31, 2012, respectively. This $0.5 million increase is primarily related to an increase in labor related expenses.

Total RD&E expenses as a percent of net sales were 1.4 percent and 1.3 percent during the nine months ended March 30, 2013 and March 31, 2012, respectively. This 0.1 percent point increase in RD&E as a percentage of net sales is primarily related to the decrease in net sales and a slight increase in headcount to support new programs and anticipated growth.

Total selling general and administrative (SG&A) expenses were $8.4 million and $8.2 million during the nine months ended March 30, 2013 and March 31, 2012, respectively. This $0.2 million increase in SG&A during the nine months ended March 30, 2013 as compared to the nine months ended March 31, 2012 is primarily related to an increase in labor related expenses and to a lesser extent other overhead costs. This is partially offset by the positive impact of a non-recurring adjustment of approximately $0.5 million related to the elimination of a deferred compensation liability.

Total SG&A expenses as a percent of net sales were 3.0 percent during the nine months ended March 30, 2013 compared to 3.3 percent during the nine months ended March 31, 2012. This 0.3 percent point improvement in SG&A as a percentage of net sales is primarily related to our continued success in leveraging operating expenses and the non-recurring adjustment discussed above.

Total operating expenses were $12.2 million or 4.4 percent of net sales during the nine months ended March 30, 2013 and $11.5 million or 4.6 percent of net sales during the nine months ended March 31, 2012. The 0.2 percent point improvement in operating expenses as a percent of net sales is primarily related to our continued success in leveraging operating expenses.

Interest

Interest expense decreased to $246,000 during the nine months ended March 30, 2013 from $357,000 during the nine months ended March 31, 2012. This decrease is related to a decrease in the average balance outstanding on our line of credit.

Income Taxes

The effective tax rate for the nine months ended March 30, 2013 was 29.1 percent compared to 10.6 percent for the nine months ended March 31, 2012. The effective tax rate increased from prior year primarily due to a discrete item recorded during the nine months ended March 31, 2012 for certain tax credits that were not as significant in the first nine months of fiscal year 2013. For further information on the effective tax rate see footnote 5 of the “Notes to Consolidated Financial Statements.”

On January 2, 2013, the American Taxpayer Relief Act (ATRA) of 2012 was signed into law. As part of this legislation, the federal research and development (R&D) tax credit was retroactively reinstated for qualifying costs incurred from January 1, 2012 through December 31, 2013. Previously, we had only recognized tax benefits associated with credits generated through December 31, 2011. Due to the fact that ATRA was signed into law after the end of our second quarter, a net benefit of approximately $490,000 related to tax credits from January 1, 2012 through March 30, 2013 was recognized during the third quarter of fiscal 2013.

Our judgments regarding deferred tax assets and liabilities may change due to changes in market conditions, changes in estimates, 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.

Backlog

On March 30, 2013, we had an order backlog of approximately $64.2 million. This compares with a backlog of approximately $72.6 million on March 31, 2012. The decrease in backlog at March 30, 2013, when compared to March 31, 2012, reflects a decrease in demand partially offset by an increase in new customers and programs. Order backlog consists of purchase orders received for products expected to be shipped within the next 12 months, although shipment dates are subject to change due to design modifications or changes in other customer requirements. Order backlog should not be considered an accurate measure of future sales.

CAPITAL RESOURCES AND LIQUIDITY

Operating Cash Flow

Net cash provided by operating activities for the nine months ended March 30, 2013 was $20.8 million, compared to net cash used in operating activities of $6.9 million during the same period of the prior fiscal year. Cash flows provided by operating activities increased primarily due to improved working capital management and higher net income.

The working capital increase year-over-year is primarily related to a $10.3 million decrease in inventory, and a $12.2 million decrease in accounts receivable offset by a $15.7 million decrease in accounts payable during the nine month