

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)

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**Washington**  
(State of Incorporation)

**91-0849125**  
(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  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

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

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)	
<b>Assets</b>		
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
<b>Total current assets</b>	<b>74,568</b>	<b>61,055</b>
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
<b>Total other assets</b>	<b>5,463</b>	<b>5,501</b>
<b>Total assets</b>	<b>\$ 91,629</b>	<b>\$ 77,755</b>
<b>Liabilities and shareholders' equity</b>		
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
<b>Total current liabilities</b>	<b>33,015</b>	<b>23,611</b>
Long-term liabilities:		
Revolving loan		2,412
Other long-term obligations	767	618
<b>Total long-term liabilities</b>	<b>767</b>	<b>3,030</b>
<b>Total liabilities</b>	<b>33,782</b>	<b>26,641</b>
<b>Commitments and contingencies (Note 7)</b>		
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

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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)

	<b>Three Months Ended</b>	
	<b>April 3, 2010</b>	<b>March 28, 2009</b>
	<b>(in thousands, except per share amounts)</b>	
Net sales	\$ 51,697	\$ 44,233
Cost of sales	46,455	40,921
<b>Gross profit on sales</b>	<b>5,242</b>	<b>3,312</b>
Operating expenses:		
Research, development and engineering	796	533
Selling, general and administrative	2,216	2,340
<b>Total operating expenses</b>	<b>3,012</b>	<b>2,873</b>
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
<b>Gross profit on sales</b>	<b>12,627</b>	<b>10,535</b>
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
<b>Operating income</b>	<b>4,339</b>	<b>1,486</b>
Interest expense	77	493
<b>Income before income tax provision (benefit)</b>	<b>4,262</b>	<b>993</b>
Income tax provision (benefit)	(2,117)	217
<b>Net income</b>	<b>\$ 6,379</b>	<b>\$ 776</b>
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)	
<b>Cash flows from operating activities:</b>		
Net income	\$ 6,379	\$ 776
<b>Adjustments to reconcile net income to cash provided by operating activities:</b>		
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)	
<b>Changes in operating assets and liabilities:</b>		
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
<b>Cash provided by operating activities</b>	<b>7,648</b>	<b>108</b>
<b>Cash flows from investing activities:</b>		
Purchase of property and equipment	(1,542)	(256)
Proceeds from sale of property and equipment	7	
<b>Cash used in investing activities</b>	<b>(1,535)</b>	<b>(256)</b>
<b>Cash flows from financing activities:</b>		
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
<b>Cash used in financing activities</b>	<b>(2,232)</b>	<b>(1,722)</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>3,881</b>	<b>(1,870)</b>
Cash and cash equivalents, beginning of period	729	2,879
<b>Cash and cash equivalents, end of period</b>	<b>\$ 4,610</b>	<b>\$ 1,009</b>
<b>Supplemental cash flow information:</b>		
Interest payments	\$ 98	\$ 509
Income tax payments, net of refunds	\$ 173	\$ 400

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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<sup>TM</sup> and the Hierarchy of Generally Accepted Accounting Principles*. This statement establishes the FASB Accounting Standards Codification<sup>TM</sup> (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):

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

**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:

	<b>Three Months Ended</b>	
	<b>(in thousands, except per share information)</b>	
	<b>April 3, 2010</b>	<b>March 28, 2009</b>
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

	<b>Nine Months Ended</b>	
	<b>(in thousands, except per share information)</b>	
	<b>April 3, 2010</b>	<b>March 28, 2009</b>
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

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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				Total Fair Value
	Level 1	Level 2	Level 3	Netting Adjustment <sup>(1)</sup>	
Financial Assets:					
Foreign currency forward contracts	\$	\$ 1,506	\$	\$	\$ 1,506

<sup>(1)</sup> 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				Total Fair Value
	Level 1	Level 2	Level 3	Netting Adjustment <sup>(1)</sup>	
Financial Assets:					
Foreign currency forward contracts	\$	\$ 912	\$	\$	\$ 912

<sup>(1)</sup> 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

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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):

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

<sup>(1)</sup> 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):

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

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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
<b>Total</b>	<b>\$ 912</b>	<b>\$ 1,407</b>	<b>\$ (1,310)</b>	<b>\$ 1,009</b>

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.

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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.

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Delivery has occurred or services have been rendered.

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

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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

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Income before income taxes	4.3	0.7	3.1	0.7
Income tax (benefit) provision	(4.2)	0.1	(1.5)	0.1
Net income	8.5%	0.6%	4.6%	0.6%

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### Sales

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.

Sales to our largest customers may vary significantly from quarter to quarter depending on the size and timing of customer program commencement, forecasts, delays, supply chain constraints 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. Only a short window of approximately three to six months of total demand information is provided to us by our customers. We seek to maintain flexibility in production capacity by employing skilled temporary and short-term labor and by generally 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

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, timing of the start up of new programs, 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. Specifically, we had provisions for obsolete inventory of \$1.4 million and \$0.2 million for the first nine months of fiscal year 2010 and 2009, respectively. We adjust the allowance for estimated obsolescence as necessary in an amount equal to the difference between the cost of inventory and estimated market value based on assumptions of 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 operating expenses were \$3.0 million in the third quarter of fiscal year 2010 and \$2.9 million in the third quarter of fiscal year 2009. Operating expenses as a percentage of sales decreased to 5.8% in the third quarter of fiscal year 2010 from 6.5% in the third quarter of fiscal year 2009. Operating expenses for the first nine months of fiscal year 2010 were \$8.3 million compared to \$9.1 million in the first nine months of fiscal year 2009. Operating expenses as a percentage of sales decreased to 6.0% in the first nine months of fiscal year 2010 from 6.5% in the first nine months of fiscal year 2009. The decrease in total operating expenses during the first nine months of fiscal year 2010 when compared to the same period of fiscal year 2009, was mainly due to the goodwill impairment charge recorded in 2009.

Total SG&A expenses were relatively flat at \$2.2 million and \$2.3 million during the third quarters of fiscal years 2010 and 2009, respectively. SG&A as a percentage of sales decreased to 4.3% in the third quarter of fiscal year 2010 from 5.3% in the third quarter of fiscal 2009. This approximate 1% improvement was the result of improved leveraging due to higher sales during the third quarter of fiscal 2010 as compared with the third quarter of fiscal 2009. SG&A expenses for the first nine months of fiscal



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year 2010 were \$6.2 million compared to \$6.5 million in the first nine months of fiscal year 2009. Lower SG&A expense for the first nine months of fiscal 2010 compared to the same periods of fiscal 2009 were attributable to lower charges for doubtful receivables and lower payroll expense due to a workforce reduction which was partially offset by higher incentive compensation. For the first nine months of fiscal year 2010 there was no bad debt expense regarding the collection of receivables. A charge of \$0.6 million for bad debt expense was recorded in the first nine months of fiscal year 2009. SG&A as a percentage of sales decreased to 4.5% in the first nine months of fiscal year 2010 from 4.7% in the first nine months of fiscal 2009. This approximate 0.2% improvement is the result of improved leveraging due to lower costs during the first nine months of fiscal 2010 as compared with the first nine months of fiscal 2009.

Total research, development, and engineering (RD&E) expenses were \$0.8 million and \$0.5 million during the third quarters of fiscal years 2010 and 2009, respectively. RD&E expenses were \$2.1 million and \$1.8 million in the first nine months of fiscal 2010 and 2009, respectively. Higher RD&E expenses in the third quarter and the first nine months of fiscal year 2010 compared to the same periods of fiscal year 2009 were the result of higher incentive compensation.

**Interest**

Interest expense decreased to approximately \$13,000 in the third quarter of fiscal year 2010 from approximately \$131,000 in the third quarter of fiscal year 2009. For the first nine months of fiscal years 2010 and 2009, interest expense amounted to \$0.1 million and \$0.5 million, respectively. The decreases in interest expense in the third quarter and first nine months of fiscal year 2010 compared to the same periods of fiscal year 2009 are due to a decrease in the average outstanding revolving credit facility balance and a decrease in variable interest rates.

**Income Taxes**

The Company had domestic income tax loss carryforwards of approximately \$33.2 million at June 27, 2009. The majority of these income tax loss carryforwards do not begin to expire until the years 2020 through 2025. 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 maintained a valuation allowance on a portion of its deferred tax assets. However, based on sustained profitability, revenue growth, new customer programs, and forecasted profits in future years management determined that during the third quarter of fiscal year 2010 an allowance was no longer necessary on the domestic income tax loss carryforwards. Based on updated forecasts, manufacturing cost reductions and new business recently acquired, management has determined that it is more than likely that all of the remaining income tax loss carryforwards will be utilized prior to their expiration. Even at current profitability levels, with no revenue growth, we believe we will be able to utilize the NOLs prior to expiration. The Company has now been profitable for the past 25 straight quarters, generating domestic taxable income in each of those quarters. In addition, the Company can employ certain tax strategies, including repatriation of foreign income, if it became evident that the income tax loss carryforwards might not be fully utilized based solely on domestic operating income. However, these tax strategies will not be necessary if our future pretax earnings are stable at the current levels. The release of the valuation allowance during the quarter ended April 3, 2010 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.

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 income tax expense or benefit in subsequent periods.

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 effect 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.

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### **Backlog**

On April 3, 2010, we had an order backlog of approximately \$49.9 million. This compares with a backlog of approximately \$29.7 million on March 28, 2009. The change in backlog at April 3, 2010 compared to March 28, 2009, was due to orders from the additional new customers we added this year. 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 April 3, 2010 was \$7.6 million, compared to \$0.1 million provided during the same period of the prior fiscal year. The year over year difference consisted primarily of net income of \$6.4 million, an \$8.0 million increase in accounts payable offset by a \$5.2 million increase in inventory and a \$2.2 million increase in accounts receivable.

Net income increased due to higher gross margins related to product mix and decreased payroll costs during the nine months ending April 3, 2010. The increase in inventory was attributable to new customer programs and increasing lead times on certain components which led to some scheduled shipments not being shipped by the end of the quarter. We purchase inventory based on customer forecasts and orders and expected lead times, and when those forecasts cannot be met or changes are made to lead times, inventory can increase. The increase in accounts payable was primarily driven by the increase in inventory and extending payment terms during the first nine months of fiscal year 2010. Accounts payable fluctuates with changes in inventory levels and negotiated supplier terms. The increased accounts receivable was due to the increase in sales that occurred during third quarter of fiscal year 2010 that had not yet been collected.

### **Investing Cash Flow**

During the first nine months of fiscal year 2010, we spent \$1.5 million for capital additions compared to \$0.3 million in the same period of the previous fiscal year. Additional capital expenditures are anticipated during the next quarter to support new customer programs but there are no firm purchase commitments as of April 3, 2010. Our capital expenditures primarily consist of purchases of manufacturing equipment to support our production facilities. We also use leases to acquire equipment. Operating leases are often utilized when potential technical obsolescence and funding requirement advantages outweigh the benefits of equipment ownership. Capital expenditures and periodic lease payments are expected to be funded by cash flow generated from operations.

### **Financing Cash Flow**

Our primary financing activity during the first nine months of fiscal years 2010 and 2009 was borrowing and repayment under our revolving line of credit facility. Our credit agreement with Wells Fargo Bank N.A. provides a revolving line of credit facility of up to \$20 million, subject to availability. 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. As of April 3, 2010, we were in compliance with our loan covenants and \$20.0 million was available under the revolving line of credit facility.

Our cash requirements are affected by the level of current operations and new EMS programs. We believe that projected cash from operations, funds available under the revolving credit facility and leasing capabilities will be sufficient to meet our working and fixed capital requirements for the foreseeable future.

## **RISKS AND UNCERTAINTIES THAT MAY AFFECT FUTURE RESULTS**

*The following risks and uncertainties could affect our actual results and could cause results to differ materially from past results or those contemplated by our forward-looking statements. When used herein, the words *expects*, *believes*, *anticipates* and similar expressions are intended to identify forward-looking statements.*

### **Potential Fluctuations in Quarterly Results**

Our quarterly operating results have varied in the past and may vary in the future due to a variety of factors, including adverse changes in the U.S. and global macroeconomic environment, volatility in overall demand for our customers' products, success of customers' programs, timing of

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new programs, new product introductions or technological advances by us, our customers and our competitors, and changes in pricing policies by us, our customers, our suppliers, and our competitors. Our customer base is diverse



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in the markets they serve, however, decreases in demand, particularly from customers that supply the banking and gambling industries, could affect future quarterly results. Additionally, our customers could be impacted by the illiquidity of the credit markets which could directly impact our operating results.

Component procurement, production schedules, personnel and other resource requirements are based on estimates of customer requirements. Occasionally, our customers may request accelerated production that can stress resources and reduce operating margins. In addition, because many of our operating expenses are relatively fixed, a reduction in customer demand can harm our gross profit and operating results. The products which we manufacture for our customers have relatively short product lifecycles. Therefore, our business, operating results and financial condition are dependent in significant way on our ability to obtain orders from new customers and new product programs from existing customers.

Operating results can also fluctuate if changes are made to significant estimates and assumptions. Significant estimates and assumptions include the allowance for doubtful receivables, provision for obsolete and non-saleable inventory, the valuation allowance on deferred tax assets, valuation of goodwill, impairment of long-lived assets, long-term incentive compensation accrual, and the provision for warranty costs.

## Economic Conditions

Recently there have been adverse conditions and uncertainty in the global economy as the result of unstable global financial and credit markets, inflation, and recession. These unfavorable economic conditions and the weakness of the credit market could affect the demand for our customers' products. If the current global macroeconomic environment continues some of our customers could continue to reduce orders and change forecasts which could adversely affect our sales in future periods. Additionally, the financial strength of our customers and suppliers and their ability to obtain and rely on credit financing may affect their ability to fulfill their obligations to us and have an adverse affect on our financial results.

## Credit Markets

The current illiquidity and financial instability in the credit markets could adversely impact lenders and potentially limit the ability of our suppliers and customers to borrow. This may affect their ability to fulfill their obligations to us and have an adverse affect on our financial results.

## Dependence on Suppliers

We are dependent on many suppliers, including sole source suppliers, to provide key components and raw materials used in manufacturing customers' products. Recently, over the past few quarters we have seen supply shortages in certain electronic components. This has resulted in longer lead times and the inability to meet our customers request for flexible production and we have missed or extended shipment dates. If demand for these components continues to outpace supply capacity these delays could further affect future operations. Delays in deliveries from suppliers or the inability to obtain sufficient quantities of components and raw materials could cause delays or reductions in shipment of products to our customers which could adversely affect our operating results and damage customer relationships.

## Concentration of Credit Risk

Cash and cash equivalents are exposed to concentrations of credit risk. We place our cash with high credit quality institutions. At times, such balances may be in excess of the federal depository insurance limit or may be on deposit at institutions which are not covered by insurance. If such institutions were to become insolvent during which time it held our cash and cash equivalents in excess of the insurance limit, it could be necessary to obtain other credit financing to operate our facilities.

## Competition

The EMS industry is intensely competitive. Competitors may offer customers lower prices on certain high volume programs. This could result in price reductions, reduced margins and loss of market share, all of which would materially and adversely affect our business, operating results, and financial condition. If we were unable to provide comparable or better manufacturing services at a lower cost than our competitors, it could cause sales to decline. In addition, competitors can copy our non-proprietary designs after we have invested in development of products for customers, thereby enabling such competitors to offer lower prices on such products due to savings in development costs.



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### **Concentration of Major Customers**

At present, our customer base is highly concentrated and could become more or less concentrated. Our largest EMS customer accounted for 14% of net sales in fiscal year 2009. This same customer accounted for 15% of sales in 2008, and 18% in 2007. For the fiscal years ended 2009, 2008, and 2007, the five largest customers accounted for 52%, 68%, and 73% of total sales, respectively. There can be no assurance that our principal customers will continue to purchase products from us at current levels. Moreover, we typically do not enter into long-term volume purchase contracts with our customers, and our customers have certain rights to extend or delay the shipment of their orders. We, however, require that our customers contractually agree to buy back inventory purchased within specified lead times to build their products if not used.

The loss of one or more of our major customers, or the reduction, delay or cancellation of orders from such customers, due to economic conditions or other forces, could materially and adversely affect our business, operating results and financial condition. Specifically, some of our major customers provide products to the banking and gambling industries which have been adversely affected by the unfavorable economic environment. The contraction in demand from our customers in these industries could continue to impact our customer orders and continue to have a negative impact on our operations over the next several fiscal quarters. Additionally, if one or more of our customers were to become insolvent or otherwise unable to pay for the manufacturing services provided by us, our operating results and financial condition would be adversely affected.

### **Foreign Manufacturing Operations**

Most of the products manufactured by us are produced at our facilities located in Mexico and China. These international operations may be subject to a number of risks, including:

difficulties in staffing and managing foreign operations;

political and economic instability (including acts of terrorism, civil unrest and outbreaks of war), which could impact our ability to ship and/or receive product;

unexpected changes in regulatory requirements and laws;

longer customer payment cycles and difficulty collecting accounts receivable;

export duties, import controls and trade barriers (including quotas);

governmental restrictions on the transfer of funds;

burdens of complying with a wide variety of foreign laws and labor practices;

fluctuations in currency exchange rates, which could affect component costs, local payroll, utility and other expenses; and

inability to utilize net operating losses incurred by our foreign operations to reduce our U.S. income taxes;

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our foreign locations may be impacted by hurricanes, earthquakes, water shortages, tsunamis, floods, typhoons, fires, extreme weather conditions and other natural or manmade disasters.

Our operations in certain foreign locations receive favorable income tax treatment in the form of tax holidays or other incentives. In the event that such tax holidays or other incentives are not extended, are repealed, or we no longer qualify for such programs, our taxes may increase, which would reduce our net income.

Additionally, certain foreign jurisdictions restrict the amount of cash that can be transferred to the U.S or impose taxes and penalties on such transfers of cash. To the extent we have excess cash in foreign locations that could be used in, or is needed by, our operations in the United States, we may incur significant penalties and/or taxes to repatriate these funds.

### Dependence on Key Personnel

Our future success depends in large part on the continued service of our key technical, marketing and management personnel and on our ability to continue to attract and retain qualified employees. There can be no assurance that we will be successful in attracting and retaining such personnel. The loss of key employees could have a material adverse effect on our business, operating results and financial condition.

### Technological Change and New Product Risk

The markets for our customers' products is characterized by rapidly changing technology, evolving industry standards, frequent new product introductions and relatively short product life cycles. The introduction of products embodying new technologies or the emergence of new industry standards can render existing products obsolete or unmarketable. Our success will depend upon our customers' ability to enhance existing products and to develop and introduce, on a timely and cost-effective basis, new products that keep pace with technological developments and emerging industry standards and address evolving and increasingly sophisticated customer requirements. Failure of our customers to do so could substantially harm our customers' competitive positions. There can be no assurance that our customers will be successful in identifying, developing and marketing products that respond to technological change, emerging industry standards or evolving customer requirements.

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### **Interest Rate Risk**

We are exposed to interest rate risk under our revolving credit facility with interest rates based on various levels of margin added to published prime rate and LIBOR rates depending on the calculation of a certain financial covenant.

### **Compliance with Current and Future Environmental Regulation**

We are subject to a variety of domestic and foreign environmental regulations relating to the use, storage, and disposal of materials used in our manufacturing processes. If we fail to comply with any present or future regulations, we could be subject to future liabilities or the suspension of current manufacturing operations. In addition, such regulations could restrict our ability to expand our operations or could require us to acquire costly equipment, substitute materials, or incur other significant expenses to comply with government regulations.

### **Foreign Currency Fluctuations**

A significant portion of our operations are in foreign locations. As a result, transactions occur in currencies other than the U.S. dollar. Exchange rate fluctuations among other currencies used by us could directly or indirectly affect our financial results. Future currency fluctuations are dependent upon a number of factors and cannot be easily predicted. We currently use Mexican peso forward contracts to hedge foreign currency fluctuations for a portion of our Mexican peso denominated expenses. However, unexpected expenses could occur from future fluctuations in exchange rates.

### **Dilution and Stock Price Volatility**

As of April 3, 2010, there were outstanding options for the purchase of 426,494 shares of our common stock, all of which were vested and exercisable. Holders of the common stock will suffer immediate dilution to the extent outstanding options to purchase the common stock are exercised. Our stock price may be subject to wide fluctuations and possible rapid increases or declines over a short time period. These fluctuations may be due to factors specific to us such as variations in quarterly operating results or changes in earnings estimates, or to factors relating to the EMS industry or to the securities markets in general, which, in recent years, have experienced significant price fluctuations. These fluctuations often have been unrelated to the operating performance of the specific companies whose stocks are traded.

### **Disclosure and Internal Controls**

Management does not expect that our disclosure controls and internal controls and procedures will prevent all errors or fraud. A control system is designed to give reasonable, but not absolute, assurance that the objectives of the control system are met. In addition, any control system reflects resource constraints and the benefits of controls must be considered relative to their costs. Inherent limitations of a control system may include: judgments in decision making may be faulty, breakdowns can occur simply because of error or mistake and controls can be circumvented by collusion or management override. Because of inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and may not be detected.

## **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

### **Interest Rate Risk**

We are subject to the risk of fluctuating interest rates in the normal course of business. Our major market risk relates to our secured debt. Our revolving credit facility is secured by substantially all of our assets. The interest rates applicable to our revolving credit facility fluctuate with the JP Morgan Chase Bank prime rate and LIBOR rates. We did not have an amount outstanding under our revolving credit facility as of April 3, 2010. See Management's Discussion and Analysis of Financial Condition and Results of Operations Capital Resources and Liquidity and Note 4 Long-Term Debt to the Consolidated Financial Statements for additional information regarding our revolving credit facility.

### **Foreign Currency Exchange Risk**

A significant portion of our operations are in foreign locations. As a result, transactions occur in currencies other than the U.S. dollar. Exchange rate fluctuations among other currencies used by us would directly or indirectly affect our financial results. We currently use Mexican peso forward contracts to hedge foreign currency fluctuations for a portion of our Mexican peso denominated expenses. There were \$18.8 million outstanding foreign currency forward contracts as of April 3, 2010. The fair



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value of these contracts was \$1.5 and was recorded in other current assets and other long term assets in the Consolidated Balance Sheet as of April 3, 2010. See Note 9 Derivative Financial Instruments to the Consolidated Financial Statements for additional information regarding our derivative instruments.

**Item 4. Controls and Procedures**

**Evaluation of Disclosure Controls and Procedures**

It is the responsibility of our management to establish, maintain, and monitor disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934 are recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms. Additionally, these disclosure controls include controls and procedures that are designed to accumulate and communicate the information required to be disclosed to our company's Chief Executive Officer and Chief Financial Officer, allowing for timely decisions regarding required disclosures. As of the end of the period covered by this report, our management carried out an evaluation, under the supervision and with the participation of the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15(f). Based on our assessment, we believe that as of April 3, 2010, the Company's disclosure controls and procedures are effective based on that criteria.

**Changes in Internal Control over Financial Reporting**

There have been no significant changes in our internal controls over financial reporting during our third quarter ended April 3, 2010 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)).

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**PART II. OTHER INFORMATION:**

Item 1A. Risk Factors

Information regarding risk factors appear in Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations and Item 3, Quantitative and Qualitative Disclosures about Market Risk of this Form 10-Q.

There are no material changes to the risk factors set forth in Part I Item 1A in the Company's Annual Report on Form 10-K for the year ended June 27, 2009.

Item 6. Exhibits

(31.1) Certification of Chief Executive Officer (Exchange Act Rules 13(a)-14 and 15(d)-14)

(31.2) Certification of Chief Financial Officer (Exchange Act Rules 13(a)-14 and 15(d)-14)

(32.1) Certification of Chief Executive Officer (18 U.S.C. 1350)

(32.2) Certification of Chief Financial Officer (18 U.S.C. 1350)



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SIGNATURES

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

KEY TRONIC CORPORATION

/s/ Craig D. Gates  
Craig D. Gates  
President and Chief Executive Officer

Date: May 11, 2010

/s/ Ronald F. Klawitter  
Ronald F. Klawitter  
Principal Financial Officer

Date: May 11, 2010