

SPARTON CORP
Form 10-Q
February 05, 2013
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended December 31, 2012

Or

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

For the transition period from _____ to _____

Commission File Number 1-1000

Sparton Corporation

(Exact name of registrant as specified in its charter)

Edgar Filing: SPARTON CORP - Form 10-Q

Ohio
(State or other jurisdiction of
incorporation or organization)

38-1054690
(I.R.S. Employer
Identification No.)

425 N. Martingale Road, Suite 2050,
Schaumburg, Illinois
(Address of principal executive offices)

60173-2213
(Zip code)

(847) 762-5800
(Registrant's telephone number, including zip code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, 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 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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

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 January 31, 2013, there were 10,229,121 shares of common stock, \$1.25 par value per share, outstanding.

Table of Contents

TABLE OF CONTENTS

<u>PART I FINANCIAL INFORMATION</u>	3
<u>ITEM 1. FINANCIAL STATEMENTS</u>	3
<u>CONDENSED CONSOLIDATED BALANCE SHEETS AS OF DECEMBER 31, 2012 AND JUNE 30, 2012 (UNAUDITED)</u>	3
<u>CONDENSED CONSOLIDATED STATEMENTS OF INCOME FOR THE THREE MONTHS AND SIX MONTHS ENDED DECEMBER 31, 2012 AND 2011 (UNAUDITED)</u>	4
<u>CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME FOR THE THREE MONTHS AND SIX MONTHS ENDED DECEMBER 31, 2012 AND 2011 (UNAUDITED)</u>	5
<u>CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE THREE MONTHS AND SIX MONTHS ENDED DECEMBER 31, 2012 AND 2011 (UNAUDITED)</u>	6
<u>CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY FOR THE THREE MONTHS AND SIX MONTHS ENDED DECEMBER 31, 2012 AND 2011 (UNAUDITED)</u>	7
<u>NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS</u>	8
<u>ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u>	21
<u>ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u>	35
<u>ITEM 4. CONTROLS AND PROCEDURES</u>	35
<u>PART II OTHER INFORMATION</u>	35
<u>ITEM 1. LEGAL PROCEEDINGS</u>	35
<u>ITEM 1A. RISK FACTORS</u>	35
<u>ITEM 6. EXHIBITS</u>	36
<u>SIGNATURES</u>	37
<u>CERTIFICATIONS</u>	

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements.**

SPARTON CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

(Dollars in thousands, except per share amounts)

	December 31, 2012	June 30, 2012 (a)
Assets		
Current Assets:		
Cash and cash equivalents	\$ 6,066	\$ 46,950
Restricted cash	535	
Accounts receivable, net of allowance for doubtful accounts of \$334 and \$146, respectively	40,821	29,618
Inventories and cost of contracts in progress, net	45,367	35,102
Deferred income taxes	2,020	2,020
Prepaid expenses and other current assets	5,251	2,054
Total current assets	100,060	115,744
Property, plant and equipment, net	28,913	14,260
Goodwill	14,903	7,472
Other intangible assets, net	11,643	1,618
Deferred income taxes non-current	4,874	5,136
Other non-current assets	701	325
Total assets	\$ 161,094	\$ 144,555
Liabilities and Shareholders Equity		
Current Liabilities:		
Short-term bank borrowings	\$ 14,000	\$
Current portion of long-term debt	131	131
Accounts payable	17,033	17,152
Accrued salaries and wages	5,417	5,855
Accrued health benefits	1,564	1,210
Current portion of pension liability	115	323
Advance billings on customer contracts	20,718	25,836
Other accrued expenses	8,273	5,890
Total current liabilities	67,251	56,397
Pension liability non-current portion	985	990
Long-term debt non-current portion	1,473	1,538
Environmental remediation non-current portion	2,978	3,142
Total liabilities	72,687	62,067
Commitments and contingencies		
Shareholders Equity:		
Preferred stock, no par value; 200,000 shares authorized, none issued		

Edgar Filing: SPARTON CORP - Form 10-Q

Common stock, \$1.25 par value; 15,000,000 shares authorized, 10,229,121 and 10,105,759 shares issued and outstanding, respectively	12,786	12,632
Capital in excess of par value	19,932	19,579
Retained earnings	57,349	51,995
Accumulated other comprehensive loss	(1,660)	(1,718)
Total shareholders equity	88,407	82,488
Total liabilities and shareholders equity	\$ 161,094	\$ 144,555

(a) Derived from the Company's audited financial statements as of June 30, 2012.
See Notes to unaudited condensed consolidated financial statements.

Table of Contents

SPARTON CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

(Dollars in thousands, except per share amounts)

	For the Three Months Ended		For the Six Months Ended	
	December 31,	December 31,	December 31,	December 31,
	2012	2011	2012	2011
Net sales	\$ 65,979	\$ 55,370	\$ 114,999	\$ 107,203
Cost of goods sold	54,571	46,634	96,378	90,123
Gross profit	11,408	8,736	18,621	17,080
Operating Expense:				
Selling and administrative expenses	7,375	5,535	12,847	10,946
Internal research and development expenses	243	218	548	616
Amortization of intangible assets	273	110	375	221
Restructuring/impairment charges		(59)		(59)
Other operating expenses	4	13	(6)	48
Total operating expense, net	7,895	5,817	13,764	11,772
Operating income	3,513	2,919	4,857	5,308
Other income (expense)				
Interest expense	(173)	(175)	(254)	(347)
Interest income	23	24	51	48
Gain on sale of investment		127		127
Other, net	59	116	169	233
Total other income (expense), net	(91)	92	(34)	61
Income before provision for income taxes	3,422	3,011	4,823	5,369
Provision for (benefit from) income taxes	(979)	1,069	(531)	1,918
Net income	\$ 4,401	\$ 1,942	\$ 5,354	\$ 3,451
Income per share of common stock:				
Basic	\$ 0.43	\$ 0.19	\$ 0.53	\$ 0.34
Diluted	\$ 0.43	\$ 0.19	\$ 0.52	\$ 0.33
Weighted average shares of common stock outstanding:				
Basic	10,229,320	10,287,797	10,185,464	10,278,127
Diluted	10,248,424	10,325,029	10,206,913	10,319,275

See Notes to unaudited condensed consolidated financial statements.

Table of Contents

SPARTON CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(UNAUDITED)

(Dollars in thousands)

	For the Three Months Ended		For the Six Months Ended	
	December 31, 2012	December 31, 2011	December 31, 2012	December 31, 2011
Net income	\$ 4,401	\$ 1,942	\$ 5,354	\$ 3,451
Other comprehensive income (loss) Change in unrecognized pension costs, net of tax	36	(4)	58	81
Comprehensive income	\$ 4,437	\$ 1,938	\$ 5,412	\$ 3,532

Table of Contents**SPARTON CORPORATION AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(UNAUDITED)**

(Dollars in thousands)

	For the Six Months Ended	
	December 31,	December 31,
	2012	2011
Cash Flows from Operating Activities:		
Net income	\$ 5,354	\$ 3,451
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	1,472	831
Deferred income tax expense	230	1,914
Pension expense	6	14
Stock-based compensation expense	597	532
Gross profit effect of capitalized profit in inventory from acquisition	566	
Gain on sale of investment		(127)
Other	41	174
Changes in operating assets and liabilities:		
Accounts receivable	(4,306)	(515)
Inventories and cost of contracts in progress	(1,845)	207
Prepaid expenses and other assets	(2,798)	(1,191)
Advance billings on customer contracts	(5,118)	5,865
Accounts payable and accrued expenses	(3,128)	(3,436)
Net cash provided by (used in) operating activities	(8,929)	7,719
Cash Flows from Investing Activities:		
Purchase of Onyx	(43,250)	
Purchases of property, plant and equipment	(1,602)	(1,917)
Change in restricted cash	(535)	
Proceeds from sale of investment		1,750
Net cash used in investing activities	(45,387)	(167)
Cash Flows from Financing Activities:		
Short-term bank borrowings, net	14,000	
Repayment of long-term debt	(70)	(66)
Payment of debt financing costs	(408)	
Repurchase of stock	(234)	(1,476)
Proceeds from the exercise of stock options	144	50
Net cash provided by (used in) financing activities	13,432	(1,492)
Net increase (decrease) in cash and cash equivalents	(40,884)	6,060
Cash and cash equivalents at beginning of period	46,950	24,550
Cash and cash equivalents at end of period	\$ 6,066	\$ 30,610
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 258	\$ 176
Cash paid for income taxes	\$ 1,603	\$ 464
Supplemental disclosure of non-cash investing activities:		

Edgar Filing: SPARTON CORP - Form 10-Q

Accrued acquisition related working capital adjustment	\$ 2,188	\$
See Notes to unaudited condensed consolidated financial statements.		

Table of Contents

SPARTON CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(UNAUDITED)

(Dollars in thousands)

	Six Months Ended December 31, 2012						
	Common Stock		Capital		Retained Earnings	Accumulated Other Comprehensive Loss	Total
	Shares	Amount	In Excess of Par Value	Amount			
Balance at June 30, 2012	10,105,759	\$ 12,632	\$ 19,579	\$ 51,995	\$ (1,718)	\$ 82,488	
Issuance of stock	159,433	199	(199)				
Forfeiture of restricted stock	(39,811)	(50)	50				
Repurchase of stock	(20,564)	(25)	(209)			(234)	
Exercise of stock options	24,304	30	114			144	
Stock-based compensation			597			597	
Comprehensive income, net of tax				5,354	58	5,412	
Balance at December 31, 2012	10,229,121	\$ 12,786	\$ 19,932	\$ 57,349	\$ (1,660)	\$ 88,407	

	Six Months Ended December 31, 2011						
	Common Stock		Capital		Retained Earnings	Accumulated Other Comprehensive Loss	Total
	Shares	Amount	In Excess of Par Value	Amount			
Balance at June 30, 2011	10,236,484	\$ 12,796	\$ 20,635	\$ 42,487	\$ (871)	\$ 75,047	
Issuance of stock	160,641	201	(201)				
Forfeiture of restricted stock	(13,290)	(17)	17				
Repurchase of stock	(188,055)	(235)	(1,241)			(1,476)	
Exercise of stock options	10,000	12	38			50	
Stock-based compensation			532			532	
Comprehensive income, net of tax				3,451	81	3,532	
Balance at December 31, 2011	10,205,780	\$ 12,757	\$ 19,780	\$ 45,938	\$ (790)	\$ 77,685	

See Notes to unaudited condensed consolidated financial statements.

Table of Contents**SPARTON CORPORATION AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(1) Business and Basis of Presentation**

Sparton Corporation and subsidiaries (the Company or Sparton) has been in continuous existence since 1900. It was last reorganized in 1919 as an Ohio corporation. The Company is a provider of complex and sophisticated electromechanical devices with capabilities that include concept development, industrial design, design and manufacturing engineering, production, distribution, and field service. The Company serves the Medical, Military & Aerospace and Industrial & Instrumentation markets through three reportable business segments; Medical Device (Medical), Complex Systems (CS) and Defense & Security Systems (DSS). Financial information by segment is presented in Note 13. All of the Company's facilities are registered to ISO standards, including 9001 or 13485, with most having additional certifications. The Company's products and services include products for Original Equipment Manufacturers (OEM) and Emerging Technology (ET) customers that are microprocessor-based systems that include transducers, printed circuit boards and assemblies, sensors, and electromechanical components, as well as development and design engineering services relating to these product sales. Sparton also develops and manufactures sonobuoys, anti-submarine warfare (ASW) devices, used by the United States Navy and other free-world countries. Many of the physical and technical attributes in the production of sonobuoys are similar to those required in the production of the Company's other electrical and electromechanical products and assemblies.

The unaudited condensed financial statements and related footnotes have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. The financial information presented herein should be read in conjunction with the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2012, which includes information and disclosures not presented herein. All significant intercompany accounts and transactions have been eliminated in consolidation. Certain reclassifications of prior period amounts have been made to conform to the current year presentation. Subsequent events have been evaluated through the date these financial statements were issued. In the opinion of management, the unaudited condensed consolidated financial statements contain all of the adjustments, consisting of normal recurring adjustments, necessary to present fairly, in summarized form, the consolidated financial position, results of operations and cash flows of the Company. The results of operations for the three and six months ended December 31, 2012 are not necessarily indicative of the results that may be expected for the full fiscal year 2013.

(2) Acquisition of Onyx EMS, LLC

On November 15, 2012, the Company completed the acquisition of Onyx EMS, LLC (Onyx) in a \$43.25 million all-cash transaction, subject to certain post-closing adjustments and financed through the use of Company cash and borrowings under the Company's new credit facility. At December 31, 2012, the Company has recorded additional consideration of \$2.19 million in relation to a post-closing working capital adjustment, which will be settled in the Company's third fiscal quarter. The transaction includes an approximate \$4.3 million escrowed holdback which is available to fund potential seller indemnification obligations in relation to the acquisition agreement.

The acquired business, which is reported in the Company's Medical segment, provides further expansion regionally into the Minneapolis medical device corridor, diversifying the Company's customer base through both existing programs and a strong business development pipeline, and increases the number of complex sub-assembly and full device programs within Sparton. Additionally, Onyx brings solid, long-term customer relationships that will utilize Sparton's expanded list of service offerings such as our low cost country footprint in Vietnam and full engineering design capabilities. Onyx primarily manufactures medical devices for OEM and emerging technology companies, including products for cardiovascular diagnostics, hearing assistance, patient temperature and warming, point-of-care diagnostics, and surgical equipment used in intraosseous medicine. Onyx also produces products such as precision measurement instruments for monitoring air quality and pollution, commercial fire and smoke alarm systems, sensing tools, test fixtures, and complex LED assemblies.

Table of Contents

The Company is in the process of obtaining valuations of certain tangible and intangible assets and expects to complete the purchase price allocation in fiscal year 2013 after these valuations are finalized. The following table represents the preliminary allocation of the total consideration to assets acquired and liabilities assumed in the acquisition of Onyx based on Sparton's preliminary estimate of their respective fair values (in thousands):

Total purchase consideration:	
Cash	\$ 43,250
Estimated payable for post-closing working capital adjustment	2,188
Total purchase consideration	\$ 45,438
Assets acquired and liabilities assumed:	
Accounts receivable, net	\$ 6,897
Inventory	8,986
Other current assets	403
Property, plant and equipment	14,148
Intangible assets - customer relationships	10,200
Intangible assets - non-compete agreements	200
Goodwill	7,431
Accounts payable	(1,654)
Other current liabilities	(1,173)
Total assets acquired and liabilities assumed	\$ 45,438

Total purchase consideration has been preliminarily allocated to the tangible and identifiable intangible assets acquired and liabilities assumed based on their provisionally estimated fair values at the acquisition date. The Onyx acquisition has preliminarily resulted in approximately \$7.4 million of goodwill, which is expected to be deductible for tax purposes and which has been assigned entirely to the Company's Medical segment. The Company believes goodwill primarily relates to the complementary strategic fit, including regional expansion into the Minneapolis medical device corridor, resulting synergies and the acquired workforce that this business brings to existing operations. The provisional fair values of acquired identifiable intangible assets have been determined to be Level 3 under the fair value hierarchy and have been estimated based on future cash flows and customer attrition rates, discounted using an estimated weighted average cost of capital. The customer relationships are being amortized using an accelerated methodology over ten years. The non-compete agreements are being amortized on a straight-line basis over one year as the ratable decline in value over time is most consistent with the contractual nature of these assets.

Included in the Company's Condensed Consolidated Statements of Operations for the three and six months ended December 31, 2012 are net sales of approximately \$6.1 million and loss before benefit from income taxes of approximately \$0.6 million resulting from the acquisition of Onyx since November 15, 2012.

The Company incurred legal, professional and other costs related to this acquisition aggregating approximately \$0.3 million. These costs were recognized as selling and administrative expenses in the three months ended December 31, 2012.

The following table summarizes, on a pro forma basis, the combined results of operations of the Company and Onyx as though the acquisition had occurred as of July 1, 2011. The pro forma amounts presented are not necessarily indicative of either the actual consolidated results had the acquisition occurred as of July 1, 2011 or of future consolidated operating results (in thousands, except per share amounts):

	For the Three Months Ended		For the Six Months Ended	
	December 31, 2012	December 31, 2011	December 31, 2012	December 31, 2011
Net sales	\$ 71,648	\$ 68,038	\$ 133,197	\$ 131,661
Income before provision for (benefit from) income taxes	\$ 4,098	\$ 2,483	\$ 6,250	\$ 4,001
Net income	\$ 4,774	\$ 1,539	\$ 6,164	\$ 2,496
Net income per share - basic	\$ 0.47	\$ 0.15	\$ 0.61	\$ 0.24

Edgar Filing: SPARTON CORP - Form 10-Q

Net income per share	diluted	\$	0.47	\$	0.15	\$	0.60	\$	0.24
----------------------	---------	----	------	----	------	----	------	----	------

Table of Contents

Pro forma results presented above reflect: (1) incremental depreciation relating to fair value adjustments to property, plant and equipment; (2) amortization relating to fair value estimates of intangible assets; (3) elimination of Onyx interest expense relating to debt paid off in conjunction with the transaction; and (4) incremental interest expense on assumed indebtedness and amortization of capitalized financing costs incurred in connection with the transaction as though the transaction occurred as of July 1, 2011.

Additionally, acquisition related expenses of approximately \$0.3 million recognized as selling and administrative expenses in the three months ended December 31, 2012 are reflected in the pro forma results above as though they were recognized during the three months ended September 30, 2011 and have been removed from the pro forma results for the three months ended December 31, 2012. Similarly, the capitalization of approximately \$0.6 million of gross profit recognized as part of the purchase accounting for Onyx, which was fully recognized as additional cost of goods sold in the Company's fiscal 2013 second quarter statement of income is reflected in the pro forma results above as though it was recognized during the three months ended September 30, 2011 and has been removed from the pro forma results for the three months ended December 31, 2012. The non-cash capitalization of profit as part of the fair value accounting for the acquired inventory of Onyx will not impact margin percentage in future quarters.

Pro forma adjustments described above have been tax effected using Sparton's effective rate during the respective periods of approximately 36.0% during the three and six months ended December 31, 2011 and 32.0% during the three and six months ended December 31, 2012.

Pro forma results presented above for the three and six months ended December 31, 2011 include significant and unusual write-downs of inventory of approximately \$0.3 million and accounts receivable of approximately \$0.4 million related to an Onyx customer, which was excluded from the acquisition.

The pre-acquisition results of Onyx included in the pro forma results above include a fee from the former owner of approximately \$0.1 million and \$0.2 million for the three months ended December 31, 2012 and 2011, respectively, and \$0.3 million and \$0.4 million for the six months ended December 31, 2012 and 2011, respectively, to cover the compensation of certain management personnel and other services that were performed by the former owner including treasury, cash management, tax, risk and benefit management and in house legal services. The Company estimates that it will incur approximately \$0.1 million quarterly in relation to providing these types of services going forward.

(3) Inventories and Cost of Contracts in Progress

The following are the major classifications of inventory, net of interim billings, at December 31, 2012 and June 30, 2012 (in thousands):

	December 31, 2012	June 30, 2012
Raw materials	\$ 39,989	\$ 32,935
Work in process	7,803	6,143
Finished goods	8,948	6,615
Total inventory and cost of contracts in progress, gross	56,740	45,693
Inventory to which the U.S. government has title due to interim billings	(11,373)	(10,591)
Total inventory and cost of contracts in progress, net	\$ 45,367	\$ 35,102

The Company recorded inventory write-downs totaling approximately \$0.5 million and \$0.3 million for the three months ended December 31, 2012 and 2011, respectively, and \$0.5 million and \$0.4 million for the six months ended December 31, 2012 and 2011, respectively. These charges are included in cost of goods sold for the periods presented.

Table of Contents**(4) Property, Plant and Equipment, Net**

Property, plant and equipment, net consists of the following at December 31, 2012 and June 30, 2012 (in thousands):

	December 31, 2012	June 30, 2012
Land and land improvements	\$ 1,405	\$ 1,235
Buildings and building improvements	20,663	16,805
Machinery and equipment	25,803	16,082
Construction in progress	4,325	2,324
Total property, plant and equipment	52,196	36,446
Less accumulated depreciation	(23,283)	(22,186)
Total property, plant and equipment, net	\$ 28,913	\$ 14,260

Total property, plant and equipment at December 31, 2012 includes approximately \$14.1 million of fixed assets acquired in the Onyx transaction. Included in construction in progress are costs relating to a facility expansion at the Company's newly acquired Watertown, South Dakota location begun before it was acquired and expected to be completed during the Company's third quarter of fiscal 2013. Included in construction in progress at June 30, 2012 was approximately \$2.0 million related to the implementation of a new enterprise resource planning system put into service during the second quarter of fiscal 2013.

(5) Goodwill and Other Intangible Assets

Goodwill represents the excess of purchase price over the fair value of the net assets acquired in conjunction with the Company's purchases of Astro Instrumentation, LLC (Astro) in May 2006, Byers Peak, Incorporated (Byers Peak) in March 2011 and Onyx in November 2012. Goodwill related to each of these acquisitions is reflected within the Company's Medical operating segment. Changes in the carrying value of goodwill for the six months ended December 31, 2012 and year ended June 30, 2012 and the ending composition of goodwill as of December 31, 2012 and June 30, 2012 are as follows (in thousands):

	December 31, 2012	June 30, 2012
Goodwill, beginning of period	\$ 7,472	\$ 7,472
Additions to goodwill during the period	7,431	
Goodwill, end of period	\$ 14,903	\$ 7,472

	December 31, 2012	June 30, 2012
Acquired Goodwill	\$ 28,056	\$ 20,625
Accumulated impairment	(13,153)	(13,153)
Goodwill	\$ 14,903	\$ 7,472

The addition to goodwill during the six months ended December 31, 2012 represents goodwill created resulting from the acquisition of Onyx.

Table of Contents

Intangible assets represent the values assigned to customer relationships acquired in conjunction with the Company's purchases of Astro, Byers Peak and Onyx as well as the values assigned to non-compete agreements acquired in conjunction with the Company's purchase of Byers Peak and Onyx. All of the Company's intangible assets are included within the Medical Segment. The amortization periods, gross carrying amounts, accumulated amortization, accumulated impairments and net carrying values of intangible assets at December 31, 2012 and June 30, 2012 are as follows (in thousands):

	Amortization Period in Months	Gross Carrying Amount	Accumulated Amortization December 31, 2012	Accumulated Impairments	Net Carrying Value
Amortized intangible assets:					
Non-compete agreements	12-24	\$ 358	\$ (162)	\$	\$ 196
Customer relationships	120-180	18,100	(2,990)	(3,663)	11,447
		\$ 18,458	\$ (3,152)	\$ (3,663)	\$ 11,643
June 30, 2012					
Amortized intangible assets:					
Non-compete agreements	24	\$ 158	\$ (105)	\$	\$ 53
Customer relationships	120-180	7,900	(2,672)	(3,663)	1,565
		\$ 8,058	\$ (2,777)	\$ (3,663)	\$ 1,618

Sparton did not incur any significant costs to renew or alter the term of its intangible assets during the six months ended December 31, 2012. Amortization expense for the three months ended December 31, 2012 and 2011 was approximately \$0.3 million and \$0.1 million, respectively. Amortization expense for the six months ended December 31, 2012 and 2011 was approximately \$0.4 million and \$0.2 million, respectively. Aggregate amortization expense relative to existing intangible assets for the periods shown is currently estimated to be as follows (in thousands):

Fiscal Year Ending June 30,	
2013	\$ 1,571
2014	2,113
2015	1,808
2016	1,586
2017	1,364
Thereafter	3,576
Total	\$ 12,018

(6) Debt

Short-term debt Short-term debt at December 31, 2012 and June 30, 2012 reflects outstanding borrowings under its credit facilities and the current portion of the Company's industrial revenue bonds.

On November 15, 2012, the Company replaced its previous revolving line-of-credit facility with a new \$65 million credit facility with BMO Harris Bank N.A., consisting of a \$35 million revolving line-of-credit facility (the Revolving Credit) to support the Company's working capital needs and other general corporate purposes, and a \$30 million acquisition loan commitment (the Acquisition Facility) and together with the Revolving Credit, the Credit Facility) to finance permitted acquisitions, including the acquisition of Onyx.

The Credit Facility expires on November 15, 2017, is secured by substantially all assets of the Company and provides for up to an additional \$35 million in uncommitted loans available for additional Revolving Credit loans or Acquisition loans.

Edgar Filing: SPARTON CORP - Form 10-Q

Advances under the Acquisition Facility are available until November 15, 2014. Loans under the Acquisition Facility amortize in two tranches, such that loans outstanding on November 15, 2013 begin amortizing in quarterly installments equal to 2.5% of the principal amount outstanding on such date, and advances made after November 15, 2013 and outstanding on November 15, 2014 begin amortizing on the same basis.

Table of Contents

Outstanding borrowings under the Credit Facility bear interest, at the Company's option, at either LIBOR, fixed for interest periods of one, two, three or six month periods, plus 1.25% to 2.00%, or at the bank's base rate, as defined, plus 0.25% to 1.00%, based upon the Company's Total Funded Debt/EBITDA Ratio, as defined. The Company is also required to pay commitment fees on unused portions of the Credit Facility ranging from 0.25% to 0.375%, based on the Company's Total Funded Debt/EBITDA Ratio, as defined. The effective interest rate on outstanding borrowings under the Credit Facility was 1.71% at December 31, 2012.

As a condition of the Credit Facility, the Company is subject to certain customary covenants, which it was in compliance with at December 31, 2012. The Company had \$14.0 million of borrowings drawn against the Credit Facility at December 31, 2012.

At December 31, 2012 the Company had \$0.5 million of restricted cash representing cash collateral for certain letters of credit outstanding issued by PNC Bank, National Association totaling \$0.5 million. The Company intends to have these letters of credit issued by BMO Harris Bank N.A. under the Credit Facility during the Company's third quarter of fiscal 2013, eliminating the need for this cash collateral.

Long-term debt Long-term debt consists of the following at December 31, 2012 and June 30, 2012 (in thousands):

	December 31, 2012	June 30, 2012
Industrial revenue bonds, face value	\$ 1,693	\$ 1,763
Less unamortized purchase discount	(89)	(94)
Total long-term debt	1,604	1,669
Less: current portion	(131)	(131)
Long-term debt, net of current portion	\$ 1,473	\$ 1,538

In connection with its acquisition of Astro in May 2006, the Company assumed repayment of principal and interest on bonds originally issued to Astro by the State of Ohio. These bonds are Ohio State Economic Development Revenue Bonds, series 2002-4. Astro originally entered into the loan agreement with the State of Ohio for the issuance of these bonds to finance the construction of the Company's Ohio operating facility. The principal amount, including premium, was issued in 2002 and totaled approximately \$2.9 million. These bonds have interest rates which vary, dependent on the maturity date of the bonds ranging from 5.00% to 5.45%. Due to an increase in interest rates since the original issuance of the bonds, a discount amounting to approximately \$0.2 million on the date of assumption by Sparton was recorded.

The bonds carry certain sinking fund requirements generally obligating the Company to make monthly deposits of one twelfth of the annual obligation plus accrued interest. The purchase discount is being amortized ratably over the remaining term of the bonds. The Company also has an irrevocable letter of credit in the amount of approximately \$0.3 million, which is renewable annually, to secure repayment of a portion of the bonds.

(7) Fair Value Measurements

The Company's long-term debt instruments, consisting of industrial revenue bonds, are carried at historical cost. As of December 31, 2012 and June 30, 2012, the fair value of the industrial revenue bonds was approximately \$2.0 million and \$2.1 million, respectively, compared to carrying values of approximately \$1.6 million and \$1.7 million, respectively. These fair values, which were derived from discounted cash flow analyses based on the terms of the contracts and observable market data, and adjustment for nonperformance risk, are classified as level 3 in the fair value hierarchy. The fair value of accounts receivable, accounts payable and borrowings under the Company's Credit Facility approximated their carrying values at both December 31, 2012 and June 30, 2012 due to their short-term nature and the fact that the interest rates approximated market rates. In relation to the acquisition of Onyx, the Company estimated the fair value of the assets acquired and liabilities assumed at acquisition date. See Note 2 for a further discussion of these estimated fair values.

Table of Contents**(8) Income Taxes**

During the three months ended December 31, 2012, the Company recognized a \$2.1 million income tax benefit from claiming a worthless stock and bad debt deduction with respect to its investments and advances to its 100% owned Canadian subsidiary, Sparton of Canada, Ltd. Sparton of Canada, Ltd. is the legal entity that held the Company's Canadian operations until these operations were ceased during fiscal 2009.

Excluding this discrete tax benefit, the Company recognized income tax provisions of approximately \$1.1 million and \$1.6 million, or approximately 32% of income before provision for income taxes, for each of the three and six months ended December 31, 2012. For the three and six months ended December 31, 2011, the Company recognized income tax provisions of approximately \$1.1 million and \$1.9 million, or approximately 36% of income before provision for income tax for each period. The Company's effective income tax rate for the interim periods presented is based on management's estimate of the Company's effective tax rate for the applicable year and differs from the Federal statutory income tax rate primarily due to applicable permanent differences, foreign income taxes and state income taxes. The fiscal 2013 effective rate was favorably impacted in comparison to the rate in the prior year periods by the domestic manufacturing deduction. The use of this deduction in fiscal 2012 was limited due to the use of net operating loss carryovers to offset Federal taxable income during that year.

(9) Defined Benefit Pension Plan

Approximately 400 employees and retirees of the Company are covered by a defined benefit pension plan. Effective April 1, 2009, participation and the accrual of benefits in this pension plan were frozen, at which time all participants became fully vested. The components of net periodic pension expense are as follows for the three months ended December 31, 2012 and 2011 (in thousands):

	For the Three Months Ended		For the Six Months Ended	
	December 31, 2012	December 31, 2011	December 31, 2012	December 31, 2011
Service cost	\$	\$	\$	\$
Interest cost	67	97	171	209
Expected return on plan assets	(117)	(170)	(257)	(280)
Amortization of prior service cost				
Amortization of unrecognized net actuarial loss	81	(38)	92	21
Net pension expense (income)	31	(111)	6	(50)
Pro rata recognition of lump-sum settlements	(25)	32		64
Total pension expense (income)	\$ 6	\$ (79)	\$ 6	\$ 14

The Company's policy is to fund the plan based upon legal requirements and tax regulations. During each of the six months ended December 31, 2012 and 2011, approximately \$0.1 million was contributed to the pension plan, reflective of required funding and discretionary funding to ensure funding levels are in excess of 80%. For further information on future funding projections and other pension disclosures see Part II, Item 8, Note 9 Employee Retirement Benefit Plans of the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2012.

Table of Contents**(10) Commitments and Contingencies**

Environmental Remediation Sparton has been involved with ongoing environmental remediation since the early 1980 s related to one of its former manufacturing facilities, located in Albuquerque, New Mexico (Coors Road). Although the Company entered into a long-term lease of the Coors Road property that was accounted for as a sale of property during fiscal 2010, it remains responsible for the remediation obligations related to its past operation of this facility. At December 31, 2012, Sparton had accrued approximately \$3.4 million as its estimate of the remaining minimum future undiscounted financial liability with respect to this matter, of which approximately \$0.4 million is classified as a current liability and included on the balance sheet in other accrued expenses. The Company s minimum cost estimate is based upon existing technology and excludes certain legal costs, which are expensed as incurred. The Company s estimate includes equipment and operating and maintenance costs for onsite and offsite pump and treat containment systems, as well as continued onsite and offsite monitoring. It also includes periodic reporting requirements.

In fiscal 2003, Sparton reached an agreement with the United States Department of Energy (DOE) and others to recover certain remediation costs. Under the settlement terms, Sparton received cash and obtained some degree of risk protection as the DOE agreed to reimburse Sparton for 37.5% of certain future environmental expenses in excess of \$8.4 million incurred from the date of settlement, if any, of which approximately \$4.4 million has been expended as of December 31, 2012 toward the \$8.4 million threshold. Uncertainties associated with environmental remediation contingencies are pervasive and often result in wide ranges of reasonably possible outcomes. Estimates developed in the early stages of remediation can vary significantly. Normally a finite estimate of cost does not become fixed and determinable at a specific point in time. Rather, the costs associated with environmental remediation become estimable over a continuum of events and activities that help to frame and define a liability. Factors which cause uncertainties for the Company include, but are not limited to, the effectiveness of the current work plans in achieving targeted results and proposals of regulatory agencies for desired methods and outcomes. It is possible that cash flows and results of operations could be materially affected by the impact of changes associated with the ultimate resolution of this contingency. At December 31, 2012, the Company estimates that it is reasonably possible, but not probable, that future environmental remediation costs associated with the Company s past operations at the Coors Road property, in excess of amounts already recorded and net of DOE reimbursement, could be up to \$2.4 million before income taxes over the next eighteen years.

The Company and its subsidiaries are also involved in certain existing compliance issues with the EPA and various state agencies, including being named as a potentially responsible party at several sites. Potentially responsible parties (PRP s) can be held jointly and severally liable for the clean-up costs at any specific site. The Company s past experience, however, has indicated that when it has contributed relatively small amounts of materials or waste to a specific site relative to other PRPs, its ultimate share of any clean-up costs has been minor. Based upon available information, the Company believes it has contributed only small amounts to those sites in which it is currently viewed as a PRP and that reasonably possible losses related to these compliance issues are immaterial.

U.S. Government Audits Federal government agencies, including the Defense Contract Audit Agency (DCAA) and the Defense Contract Management Agency (DCMA), routinely audit and investigate government contracts and government contractors administrative processes and systems. These agencies review the Company s performance on contracts, pricing practices, cost structure and compliance with applicable laws, regulations and standards. They also review the adequacy of the Company s internal control systems and policies, including the Company s purchasing, accounting, estimating, compensation and management information processes and systems.

The Company responded in November 2011 to DCAA review comments received in the first quarter of fiscal 2012 regarding corrective actions to improve the reliability for accumulating costs under government contracts. As a result, DCMA has determined our cost accounting system is currently adequate and the Company remains eligible to receive cost reimbursable contracts from the U.S. Government. While the Company s corrective actions remain open for further review, the Company remains confident that formal resolution of DCAA cost accounting practices findings will not have a material adverse impact on the Company s financial results.

Other In addition to the foregoing, from time to time, the Company is involved in various legal proceedings relating to claims arising in the ordinary course of business. The Company is not currently a party to any other such legal proceedings, the adverse outcome to which, individually or in the aggregate, is expected to have a material adverse effect on our business, financial condition or results of operations.

Table of Contents**(11) Stock-Based Compensation**

The Company has two long-term incentive plans. The Sparton Corporation Stock Incentive Plan, as amended and restated (the 2001 Plan) was approved by the Company s shareholders on October 24, 2001. The Sparton Corporation 2010 Long-Term Incentive Plan (the 2010 Plan) was approved by the Company s shareholders on October 28, 2009.

2001 Plan. Under the 2001 Plan, the Company may grant to employees and non-employee directors incentive and non-qualified stock options, stock appreciation rights, restricted stock and other stock-based awards. All of the stock options issued to date under the 2001 Plan have either three, five or ten-year lives with either immediate vesting or vesting on an annual basis over four years beginning one year after grant date. Restricted stock awards granted to date to employees under the 2001 Plan vest annually over periods ranging from approximately 2.5 to 4.0 years, in some cases subject to achievement of certain financial performance metrics in addition to the service requirements. Unrestricted stock awards granted to date under the 2001 Plan represent annual stock grants to directors as a component of their overall compensation. The 2001 Plan s termination date with respect to the granting of new awards was October 24, 2011. The total number of shares authorized to be granted under the 2001 Plan was 970,161 shares of the Company s common stock, which equals the number of underlying awards previously made under the 2001 Plan.

2010 Plan. Under the 2010 Plan, the Company may grant to employees, officers and directors of the Company or its subsidiaries incentive and non-qualified stock options, stock appreciation rights, restricted stock or restricted stock units, performance awards and other stock-based awards, including grants of shares. Restricted stock awards granted to date to employees under the 2010 Plan vest annually over four years, subject to achievement of certain financial performance metrics in addition to the service requirements. Unrestricted stock awards granted to date under the 2010 Plan represent annual stock grants to directors as a component of their overall compensation. The 2010 Plan has a term of ten years. The total number of shares that may be awarded under the 2010 Plan is 1,000,000 shares of common stock, of which amount, 581,700 shares remain available for awards as of December 31, 2012.

The following table shows stock-based compensation expense by type of share-based award for the three and six months ended December 31, 2012 and 2011 included in the condensed consolidated statements of operations (in thousands):

	For the Three Months Ended		For the Six Months Ended	
	December 31, 2012	December 31, 2011	December 31, 2012	December 31, 2011
Fair value expense of stock option awards	\$	\$	\$	\$
Restricted and unrestricted stock	333	356	597	532
Total stock-based compensation	\$ 333	\$ 356	\$ 597	\$ 532

The following table shows the total remaining unrecognized compensation cost related to restricted stock grants and the fair value expense of stock option awards, as well as the weighted average remaining required service period over which such costs will be recognized as of December 31, 2012:

	Total Remaining Unrecognized Compensation Cost (in thousands)	Weighted Average Remaining Required Service Period (in years)
Fair value expense of stock option awards	\$	
Restricted stock	1,567	2.08
	\$ 1,567	2.08

Table of Contents

The following is a summary of options outstanding and exercisable at December 31, 2012:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at June 30, 2012	101,076	\$ 7.72		
Granted				
Exercised	(24,304)	5.92		
Forfeited	(14,670)	8.06		
Expired				
Outstanding and exercisable at December 31, 2012	62,102	\$ 8.34	2.23	\$ 343

The intrinsic value of options exercised during the six months ended December 31, 2012 and 2011 was \$0.1 million and less than \$0.1 million respectively.

The following is a summary of activity for the six months ended December 31, 2012 related to shares granted under the Company's long-term incentive plans:

	Shares	Weighted Average Grant Date Fair Value
Restricted shares at June 30, 2012	305,850	\$ 6.44
Granted	146,108	10.90
Vested	(90,175)	6.25
Forfeited	(39,811)	8.05
Restricted shares at December 31, 2012	321,972	\$ 8.31

The total fair value of restricted stock vested in the six months ended December 31, 2012 and 2011 was approximately \$1.0 million and \$0.6 million, respectively.

(12) Earnings Per Share Data

Basic earnings per share is based on the weighted average number of common shares and participating securities outstanding during the period. Diluted earnings per share include the dilutive effect of additional potential common shares issuable under our stock-based compensation plan and are determined using the treasury stock method. Unvested restricted stock awards, which contain non-forfeitable rights to dividends whether paid or unpaid, are included in the number of shares outstanding for both basic and diluted earnings per share calculations. In the event of a net loss, unvested restricted stock awards are excluded from the calculation of both basic and diluted loss per share.

Earnings per share calculations, including weighted average number of shares of common stock outstanding used in calculating basic and diluted income per share, for the three months ended December 31, 2012 and 2011 are as follows:

For the Three Months Ended		For the Six Months Ended	
December 31, 2012	December 31, 2011	December 31, 2012	December 31, 2011

Edgar Filing: SPARTON CORP - Form 10-Q

Net income (in thousands)	\$ 4,401	\$ 1,942	\$ 5,354	\$ 3,451
Weighted average shares outstanding Basic	10,229,320	10,287,797	10,185,464	10,278,127
Net effect of dilutive stock options	19,104	37,232	21,449	41,148
Weighted average shares outstanding Diluted	10,248,424	10,325,029	10,206,913	10,319,275
Net income per share:				
Basic	\$ 0.43	\$ 0.19	\$ 0.53	\$ 0.34
Diluted	\$ 0.43	\$ 0.19	\$ 0.52	\$ 0.33

Table of Contents

For each of the three and six months ended December 31, 2012, 321,972 unvested restricted shares were included in determining both basic and diluted earnings per share. For each of the three and six months ended December 31, 2011, 312,650 unvested restricted shares were included in determining both basic and diluted earnings per share. Potential shares of common stock excluded from diluted income per share computations because their inclusion would be anti-dilutive were 94,001 for each of the three and six months ended December 31, 2011. No potential shares of common stock were excluded from diluted income per share computations for either the three or six months ended December 31, 2012.

(13) Business Segments

The Company is a provider of complex and sophisticated electromechanical devices with capabilities that include concept development, industrial design, design and manufacturing engineering, production, distribution, and field service. Reportable segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or group, in assessing performance and allocating resources. The Company serves the Medical, Military & Aerospace and Industrial & Instrumentation markets through three reportable business segments; Medical Device (*Medical*), Complex Systems (*CS*) and Defense & Security Systems (*DSS*).

The Company uses an internal management reporting system, which provides important financial data to evaluate performance and allocate the Company's resources on a segment basis. Net sales are attributed to the segment in which the product is manufactured or service is performed. A segment's performance is evaluated based upon its operating income (loss). A segment's operating income (loss) includes its gross profit on sales less its selling and administrative expenses, including allocations of certain corporate operating expenses, but excludes some corporate and other unallocated items such as, interest expense, interest income, other income (expense) and income tax expense (benefit). Allocations of certain corporate operating expenses are allocated based on the nature of the service provided. Corporate and other unallocated costs primarily represent corporate administrative expenses related to those administrative, financial and human resource activities which are not allocated to operations and excluded from segment profit. These costs are not allocated to the segments, as management excludes such costs when assessing the performance of the segments. Inter-segment transactions are generally accounted for at amounts that approximate arm's length transactions. Identifiable assets by segments are those assets that are used in each segment's operations. The accounting policies for each of the segments are the same as for the Company taken as a whole.

Medical Device (Medical) operations are comprised of contract development, design, production and fulfillment of sophisticated medical and biotech devices and sub-assemblies for industry leaders, emerging technologies companies and start-ups. In manufacturing devices for its customers, this business unit follows specific design and manufacturing processes to assure product reliability and safety in accordance with Food and Drug Administration (*FDA*) guidelines and approvals. This group specializes in technologies, systems and processes required by medical OEM and ET customers primarily in the Diagnostic, Therapeutic, Surgical and Neurological segments of the Medical Device and Biotech market spaces. The segment additionally produces environmental monitoring and industrial systems and controls.

Complex Systems (CS) operations provides complex electronics systems to multiple industries, offering end-to-end development and manufacturing solutions focused on high expectations of quality and delivery performance through an international footprint. As a vertically integrated business unit, this segment assists in providing its customers with seamless development of circuit card and sub-assemblies for integration into electro-mechanical solutions. By focusing on maximizing efficiency and cost containment at the various steps in the design, engineering, and manufacturing process, Complex Systems acts as an intelligent source and ideal partner for development firms and OEMs. This business unit is a supplier for low to medium volume/high complexity commercial and military aerospace applications, telecommunications, energy, and industrial controls. Its current portfolio of applications includes: flight controls, cockpit displays, fuel system controls, secure communications, early warning detection, diagnostics systems, security systems, detection systems, lighting, satellite communications, audio, nuclear detection, inventory control, and defense.

Table of Contents

Defense & Security Systems (DSS) operations are comprised of design, development and production of products for a number of technologically significant programs aimed at fulfilling defense and commercial needs. Specializing in the development and production of complex electromechanical equipment, Sparton designs and manufactures sonobuoys, ASW devices for the U.S. Navy and foreign governments that meet Department of State licensing requirements. This business unit also performs an engineering development function for the United States military and prime defense contractors for advanced technologies ultimately leading to future defense products as well as replacements for existing products. The sonobuoy product line is built to the customer's demanding specifications. These products are restricted by International Tariff and Arms Regulations (ITAR) and qualified by the U.S. Navy, which limits opportunities for competition. Additionally, this business unit internally develops and markets commercial products based on its navigation and underwater acoustic knowledge and the intrinsic skill sets of its technical staff.

Operating results and certain other financial information about the Company's three reportable segments for the three and six months ended December 31, 2012 and 2011 and as of December 31, 2012 and June 30, 2012 were as follows (in thousands):

	For the Three Months Ended December 31, 2012					
	Medical	CS	DSS	Other Unallocated	Eliminations	Total
Sales	\$ 34,804	\$ 14,059	\$ 21,402	\$	\$ (4,286)	\$ 65,979
Gross profit	\$ 4,344	\$ 1,428	\$ 5,636	\$	\$	\$ 11,408
Operating income (loss)	\$ 1,803	\$ 777	\$ 4,143	\$ (3,210)	\$	\$ 3,513
Selling and administrative expenses	\$ 2,268	\$ 651	\$ 1,250	\$ 3,206	\$	\$ 7,375
Internal research and development expenses	\$	\$	\$ 243	\$	\$	\$ 243
Depreciation/amortization	\$ 634	\$ 148	\$ 153	\$ 58	\$	\$ 993
Capital expenditures	\$ 335	\$ 20	\$ 132	\$ 57	\$	\$ 544

	For the Three Months Ended December 31, 2011					
	Medical	CS	DSS	Other Unallocated	Eliminations	Total
Sales	\$ 28,027	\$ 12,549	\$ 18,476	\$	\$ (3,682)	\$ 55,370
Gross profit	\$ 3,883	\$ 1,306	\$ 3,547	\$	\$	\$ 8,736
Operating income (loss)	\$ 2,332	\$ 600	\$ 2,404	\$ (2,417)	\$	\$ 2,919
Selling and administrative expenses	\$ 1,471	\$ 706	\$ 925	\$ 2,433	\$	\$ 5,535
Internal research and development expenses	\$	\$	\$ 218	\$	\$	\$ 218
Restructuring/impairment charges	\$ (30)	\$	\$	\$ (29)	\$	\$ (59)
Depreciation/amortization	\$ 178	\$ 134	\$ 101	\$ 13	\$	\$ 426
Capital expenditures	\$ 214	\$ 62	\$ 532	\$ 378	\$	\$ 1,186

Table of Contents**For the Six Months Ended December 31, 2012**

	Medical	CS	DSS	Other Unallocated	Eliminations	Total
Sales	\$ 62,863	\$ 26,406	\$ 34,608	\$	\$ (8,878)	\$ 114,999
Gross profit	\$ 8,538	\$ 2,524	\$ 7,559	\$	\$	\$ 18,621
Operating income (loss)	\$ 4,425	\$ 1,163	\$ 4,681	\$ (5,412)	\$	\$ 4,857
Selling and administrative expenses	\$ 3,738	\$ 1,361	\$ 2,330	\$ 5,418	\$	\$ 12,847
Internal research and development expenses	\$	\$	\$ 548	\$	\$	\$ 548
Depreciation/amortization	\$ 807	\$ 291	\$ 297	\$ 77	\$	\$ 1,472
Capital expenditures	\$ 344	\$ 726	\$ 256	\$ 276	\$	\$ 1,602

For the Six Months Ended December 31, 2011

	Medical	CS	DSS	Other Unallocated	Eliminations	Total
Sales	\$ 55,487	\$ 25,109	\$ 33,763	\$	\$ (7,156)	\$ 107,203
Gross profit	\$ 7,497	\$ 2,394	\$ 7,189	\$	\$	\$ 17,080
Operating income (loss)	\$ 4,219	\$ 943	\$ 4,645	\$ (4,499)	\$	\$ 5,308
Selling and administrative expenses	\$ 3,087	\$ 1,451	\$ 1,928	\$ 4,480	\$	\$ 10,946
Internal research and development expenses	\$	\$	\$ 616	\$	\$	\$ 616
Restructuring/impairment charges	\$ (30)	\$	\$	\$ (29)	\$	\$ (59)
Depreciation/amortization	\$ 347	\$ 264	\$ 195	\$ 25	\$	\$ 831
Capital expenditures	\$ 233	\$ 202	\$ 567	\$ 915	\$	\$ 1,917

As of December 31, 2012

	Medical	CS	DSS	Other Unallocated	Eliminations	Total
Total assets	\$ 97,695	\$ 25,852	\$ 17,220	\$ 20,327	\$	\$ 161,094

As of June 30, 2012

	Medical	CS	DSS	Other Unallocated	Eliminations	Total
Total assets	\$ 51,211	\$ 24,590	\$ 10,912	\$ 57,842	\$	\$ 144,555

(14) New Accounting Standards

In June 2011, the FASB issued ASU No. 2011-05, *Presentation of Comprehensive Income* (ASU No. 2011-05), which requires that comprehensive income be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. This standard no longer allows companies to present components of other comprehensive income only in the statement of equity. The standard also requires entities to disclose on the face of the financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net earnings. In December 2011, the FASB issued ASU No. 2011-12, *Deferral of the Effective Date for Amendments to the Presentation of Reclassification of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*, which defers indefinitely the ASU No. 2011-05 requirement that entities disclose on the face of the financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net earnings. These standards are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The adoption of this guidance did not have a significant impact on the Company's consolidated financial statements other than the prescribed change in presentation.

In September 2011, the FASB issued ASU No. 2011-08, *Testing Goodwill for Impairment*, which amends existing guidance by giving an entity the option to first assess qualitative factors to determine whether it is more likely than not (that is, a likelihood of more than 50 percent) that the fair value of a reporting unit is less than its carrying amount. If this is the case, companies will need to perform a more detailed two-step goodwill impairment test which is used to identify potential goodwill impairments and to measure the amount of goodwill impairment losses to be recognized, if any. ASU No. 2011-08 is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The adoption of this guidance did not have a significant impact on the Company's consolidated financial statements.

Table of Contents

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

The following is management's discussion and analysis of certain significant events affecting Sparton Corporation (the Company or Sparton) results of operations and financial condition during the periods included in the accompanying financial statements. Additional information regarding the Company can be accessed via Sparton's website at www.sparton.com. Information provided at the website includes, among other items, the Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Quarterly Earnings Releases, News Releases, and the Code of Business Conduct and Ethics, as well as various corporate charters and documents.

The Private Securities Litigation Reform Act of 1995 reflects Congress' determination that the disclosure of forward-looking information is desirable for investors and encourages such disclosure by providing a safe harbor for forward-looking statements by corporate management. This report on Form 10-Q contains forward-looking statements within the scope of the Securities Act of 1933 and the Securities Exchange Act of 1934. The words expects, anticipates, believes, intends, plans, will, shall, and similar expressions, and the negatives of such expressions, are intended to identify forward-looking statements. In addition, any statements which refer to expectations, projections or other characterizations of future events or circumstances are forward-looking statements. The Company undertakes no obligation to publicly disclose any revisions to these forward-looking statements to reflect events or circumstances occurring subsequent to filing this Form 10-Q with the Securities and Exchange Commission (SEC). These forward-looking statements are subject to risks and uncertainties, including, without limitation, those discussed below. Accordingly, Sparton's future results may differ materially from historical results or from those discussed or implied by these forward-looking statements. The Company notes that a variety of factors could cause the actual results and experience to differ materially from anticipated results or other expectations expressed in the Company's forward-looking statements.

Business Overview

General

Sparton is a provider of complex and sophisticated electromechanical devices with capabilities that include concept development, industrial design, design and manufacturing engineering, production, distribution, and field service. The Company serves the Medical, Military & Aerospace and Industrial & Instrumentation markets through three reportable business segments; Medical Device (Medical), Complex Systems (CS) and Defense & Security Systems (DSS).

All of the Company's facilities are registered to ISO standards, including 9001 or 13485, with most having additional certifications. The Company's products and services include products for Original Equipment Manufacturers (OEM) and Emerging Technology (ET) customers that are microprocessor-based systems that include transducers, printed circuit boards and assemblies, sensors, and electromechanical components, as well as development and design engineering services relating to these product sales. Sparton also develops and manufactures sonobuoys, anti-submarine warfare (ASW) devices used by the United States Navy and other free-world countries. Many of the physical and technical attributes in the production of sonobuoys are similar to those required in the production of the Company's other electrical and electromechanical products and assemblies.

The Company uses an internal management reporting system, which provides important financial data to evaluate performance and allocate the Company's resources on a market segment basis. Net sales for segments are attributed to the segment in which the product is manufactured or service is performed. A segment's performance is evaluated based upon its operating income (loss). A segment's operating income (loss) includes its gross profit on sales less its selling and administrative expenses, but excludes some corporate and other unallocated items such as, interest expense, interest income, other income (expense) and income tax expense (benefit). Allocations of certain corporate operating expenses are allocated based on the nature of the service provided. Corporate and other unallocated costs primarily represent corporate administrative expenses related to those administrative, financial and human resource activities which are not allocated to operations and excluded from segment profit. These costs are not allocated to the segments, as management excludes such costs when assessing the performance of the segments. Inter-segment transactions are generally accounted for at amounts that approximate arm's length transactions. The accounting policies for each of the segments are the same as for the Company taken as a whole.

Table of Contents

Medical Segment

Medical operations are comprised of contract development, design, production and fulfillment of sophisticated medical and biotech devices and sub-assemblies for industry leaders, emerging technologies companies and start-ups. In manufacturing devices for its customers, this business unit follows specific design and manufacturing processes to assure product reliability and safety in accordance with Food and Drug Administration (FDA) guidelines and approvals. This group specializes in technologies, systems and processes required by medical OEM and ET customers primarily in the Diagnostic, Therapeutic, Surgical and Neurological segments of the Medical Device and Biotech market spaces. The segment additionally produces environmental monitoring and industrial systems and controls.

Complex Systems Segment

Complex Systems operations provides complex electronics systems to multiple industries, offering end-to-end development and manufacturing solutions focused on high expectations of quality and delivery performance through an international footprint. As a vertically integrated business unit, this segment assists in providing its customers with seamless development of circuit card and sub-assemblies for integration into electro-mechanical solutions. By focusing on maximizing efficiency and cost containment at the various steps in the design, engineering, and manufacturing process, Complex Systems acts as an intelligent source and ideal partner for development firms and OEMs. This business unit is a supplier for low to medium volume/high complexity commercial and military aerospace applications, telecommunications, energy, and industrial controls. Its current portfolio of applications includes: flight controls, cockpit displays, fuel system controls, secure communications, early warning detection, diagnostics systems, security systems, detection systems, lighting, satellite communications, audio, nuclear detection, inventory control, and defense.

DSS Segment

DSS operations are comprised of design, development and production of products for a number of technologically significant programs aimed at fulfilling defense and commercial needs. Specializing in the development and production of complex electromechanical equipment, Sparton designs and manufactures sonobuoys, ASW devices for the U.S. Navy and foreign governments that meet Department of State licensing requirements. This business unit also performs an engineering development function for the United States military and prime defense contractors for advanced technologies ultimately leading to future defense products as well as replacements for existing products. The sonobuoy product line is built to the customer's demanding specifications. These products are restricted by International Tariff and Arms Regulations (ITAR) and qualified by the U.S. Navy, which limits opportunities for competition. Additionally, this business unit internally develops and markets commercial products based on its navigation and underwater acoustic knowledge and the intrinsic skill sets of its technical staff.

Risks and Uncertainties

Sparton, as a high-mix, low to medium volume supplier, provides rapid product turnaround for customers. High-mix describes customers needing multiple product types with generally low to medium volume manufacturing runs. As a contract manufacturer with customers in a variety of markets, the Company has substantially less visibility of end user demand and, therefore, forecasting sales can be problematic. Customers may cancel their orders, change production quantities and/or reschedule production for a number of reasons. Depressed economic conditions may result in customers delaying delivery of product, or the placement of purchase orders for lower volumes than previously anticipated. Unplanned cancellations, reductions, or delays by customers may negatively impact the Company's results of operations. As many of the Company's costs and operating expenses are relatively fixed within given ranges of production, a reduction in customer demand can disproportionately affect the Company's gross margins and operating income. The majority of the Company's sales have historically come from a limited number of customers. Significant reductions in sales to, or a loss of, one of these customers could materially impact our operating results if the Company were not able to replace those sales with new business.

Table of Contents

Other risks and uncertainties that may affect our operations, performance, growth forecasts and business results include, but are not limited to, timing and fluctuations in U.S. and/or world economies, sharp volatility of world financial markets over a short period of time, competition in the overall contract manufacturing business, availability of production labor and management services under terms acceptable to the Company, Congressional budget outlays for sonobuoy development and production, Congressional legislation, uncertainties associated with the outcome of litigation, changes in the interpretation of environmental laws and the uncertainties of environmental remediation and customer labor and work strikes. Further risk factors are the availability and cost of materials, as well as non-cancelable purchase orders we have committed to in relation to customer forecasts that can be subject to change. A number of events can impact these risks and uncertainties, including potential escalating utility and other related costs due to natural disasters, as well as political uncertainties such as the unrest in Africa and the Middle East. Additional trends, risks and uncertainties include dependence on key personnel, risks surrounding acquisitions, uncertainties surrounding the global economy and U.S. healthcare legislation and the effects of those uncertainties on OEM behavior, including heightened inventory management, product development cycles and outsourcing strategies. Finally, the Sarbanes-Oxley Act, and more recently the Dodd-Frank Act, have required or will require changes in, and formalization of, some of the Company's corporate governance and compliance practices. The SEC and the New York Stock Exchange have also passed or will pass related rules and regulations requiring additional compliance activities, including those implementing the conflict minerals provisions of the Dodd-Frank Act. Compliance with these rules has increased administrative costs and may increase these costs further in the future. A further discussion of the Company's risk factors has been included in Part I, Item 1A. Risk Factors, of the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2012. Management cautions readers not to place undue reliance on forward-looking statements, which are subject to influence by the enumerated risk factors as well as unanticipated future events.

Acquisition

On November 15, 2012, the Company completed the acquisition of Onyx EMS, LLC (Onyx) in a \$43.25 million all-cash transaction, subject to certain post-closing adjustments and financed through the use of Company cash and borrowings under the Company's new credit facility. At December 31, 2012, the Company has recorded additional consideration of \$2.19 million in relation to a post-closing working capital adjustment, which will be settled in the Company's third fiscal quarter. The transaction includes an approximate \$4.3 million escrowed holdback which is available to fund potential seller indemnification obligations in relation to the acquisition agreement.

The acquired business, which is reported in the Company's Medical segment, provides further expansion regionally into the Minneapolis medical device corridor, diversifying the Company's customer base through both existing programs and a strong business development pipeline, and increases the number of complex sub-assembly and full device programs within Sparton. Additionally, Onyx brings solid, long-term customer relationships that will utilize Sparton's expanded list of service offerings such as our low cost country footprint in Vietnam and full engineering design capabilities. Onyx primarily manufactures medical devices for OEM and emerging technology companies, including products for cardiovascular diagnostics, hearing assistance, patient temperature and warming, point-of-care diagnostics, and surgical equipment used in intraosseous medicine. Onyx also produces products such as precision measurement instruments for monitoring air quality and pollution, commercial fire and smoke alarm systems, sensing tools, test fixtures, and complex LED assemblies.

Total purchase consideration has been preliminarily allocated to the tangible and identifiable intangible assets acquired and liabilities assumed based on their provisionally estimated fair values at the acquisition date. The Onyx acquisition has preliminarily resulted in approximately \$7.4 million of goodwill, which is expected to be deductible for tax purposes and which has been assigned entirely to the Company's Medical segment. The Company believes goodwill primarily relates to the complementary strategic fit, including regional expansion into the Minneapolis medical device corridor, resulting synergies and the acquired workforce that this business brings to existing operations. The provisional fair values of acquired identifiable intangible assets have been determined to be Level 3 under the fair value hierarchy and have been estimated based on future cash flows and customer attrition rates, discounted using an estimated weighted average cost of capital. The customer relationships are being amortized using an accelerated methodology over ten years. The non-compete agreements are being amortized on a straight-line basis over one year as the ratable decline in value over time is most consistent with the contractual nature of these assets.

The Company incurred legal, professional and other costs related to this acquisition aggregating approximately \$0.3 million. These costs were recognized as selling and administrative expenses in the three months ended December 31, 2012.

Table of Contents

The following table summarizes, on a pro forma basis, the results of operations of Onyx as though the acquisition had occurred as of July 1, 2011. The pro forma amounts presented are not necessarily indicative of either the actual consolidated results had the acquisition occurred as of July 1, 2011 or of future operating results (in thousands):

	For the Three Months Ended December 31,				For the Six Months Ended December 31,			
	Pre Acquisition	2012 Post Acquisition	Onyx Pro Forma	2011 Onyx Pro Forma	Pre Acquisition	2012 Post Acquisition	Onyx Pro Forma	2011 Onyx Pro Forma
Net sales	\$ 5,669	\$ 6,115	\$ 11,784	\$ 12,668	\$ 18,198	\$ 6,115	\$ 24,313	\$ 24,458
Gross profit	\$ 665	\$ 867	\$ 1,532	\$ 1,582	\$ 2,920	\$ 867	\$ 3,787	\$ 2,821
Operating income	\$ (99)	\$ (1)	\$ (100)	\$ (449)	\$ 712	\$ (1)	\$ 711	\$ (921)

Depreciation and amortization reflected in the above numbers

	\$ 620	\$ 459	\$ 1,079	\$ 1,027	\$ 1,551	\$ 459	\$ 2,010	\$ 2,054
--	--------	--------	----------	----------	----------	--------	----------	----------

Pro forma results presented above reflect: (1) incremental depreciation relating to fair value adjustments to property, plant and equipment; (2) amortization relating to fair value estimates of intangible assets; and (3) elimination of Onyx interest expense relating to debt paid off in conjunction with the transaction as though the transaction occurred as of July 1, 2011.

Additionally, the capitalization of approximately \$0.6 million of gross profit recognized as part of the purchase accounting for Onyx, which was fully recognized as additional cost of goods sold in the Company's fiscal 2013 second quarter statement of income is reflected in the pro forma results above as though it was recognized during the three months ended September 30, 2011 and has been removed from the pro forma results for the three months ended December 31, 2012. The non-cash capitalization of profit as part of the fair value accounting for the acquired inventory of Onyx will not impact margin percentage in future quarters.

Pro forma adjustments described above have been tax effected using Sparton's effective rate during the respective periods of approximately 36.0% during the three and six months ended December 31, 2011 and 32.0% during the three and six months ended December 31, 2012.

Pro forma results presented above for the three and six months ended December 31, 2011 include significant and unusual write-downs of inventory of approximately \$0.3 million and accounts receivable of approximately \$0.4 million related to an Onyx customer, which was excluded from the acquisition.

The pre-acquisition results of Onyx included in the pro forma results above include a fee from the former owner of approximately \$0.1 million and \$0.2 million for the three months ended December 31, 2012 and 2011, respectively, and \$0.3 million and \$0.4 million for the six months ended December 31, 2012 and 2011, respectively, to cover the compensation of certain management personnel and other services that were performed by the former owner including treasury, cash management, tax, risk and benefit management and in house legal services. The Company estimates that it will incur approximately \$0.1 million quarterly in relation to providing these types of services going forward.

Consolidated Results of Operations

The following discussion should be read in conjunction with the Unaudited Condensed Consolidated Financial Statements and Notes thereto included in Item 1 of this report.

Table of Contents**Summary**

The major elements affecting net income for the three and six months ended December 31, 2012 as compared to the three and six months ended December 31, 2011 were as follows (in millions):

	For the Three Months Ended December 31,	For the Six Months Ended December 31,
Net income fiscal 2012	\$ 1.9	\$ 3.5
Increased gross profit from acquired Medical business	\$ 0.3	\$ 0.3
Increased gross profit on legacy Medical programs	0.2	0.7
Increased gross profit on CS programs	0.1	0.1
Increased gross profit on DSS programs	2.1	0.4
Increased selling and administrative expenses from acquired Medical business	(0.7)	(0.7)
Increased selling and administrative expenses from legacy business	(1.1)	(1.2)
Decreased internal research and development expenses		0.1
Amortization of intangible assets	(0.2)	(0.2)
Interest expense		0.1
Income taxes	2.1	2.4
Other	(0.3)	(0.1)
Net change	2.5	1.9
Net income fiscal 2013	\$ 4.4	\$ 5.4

To date, fiscal 2013 was impacted by:

Incremental gross profit on Medical programs acquired from Onyx.

Increased gross profit on legacy Medical programs due mainly to certain favorable product mix, partially offset by decreased capacity utilization at the Strongsville, Ohio facility in the second quarter.

Slightly increased gross profit on CS programs due to increased sales.

Increased gross profit on DSS programs in the second quarter due to increased sonobuoy sales to foreign governments partially offset by decreased sales to the U.S. Navy. Increased gross profit on DSS programs in the first six months due to increased sales to the U.S. Navy and increased digital compass sales, partially offset by decreased sonobuoy sales to foreign governments.

Increased selling and administrative expenses related to the Company's new Watertown, South Dakota facility.

Increased selling and administrative expenses reflecting professional and travel expenses relating to the pursuit of acquisitions, costs related to the Company's overall transformation of its finance organization and increased business development costs.

Edgar Filing: SPARTON CORP - Form 10-Q

Reduced internal research and development expenses of approximately \$0.1 million in the six months ended December 31, 2012 compared to the fiscal 2012 period.

Fiscal 2013 amortization of customer relationships and non-compete agreements acquired with Onyx.

Decreased interest expense of approximately \$0.1 million in the six months ended December 31, 2012, reflecting decreased amortization of financing fees in the current year period, partially offset by second quarter fiscal 2013 expense under the Company's new credit facility.

Fiscal 2013 second quarter recognition of tax benefit relating to Canadian worthless stock and bad deduction. Additionally, first quarter effective income tax rate of 32% compared to an effective income tax rate of 36% in the comparative prior year quarter, reflecting an increased domestic manufacturing deduction. The use of this deduction in fiscal 2012 was limited due to the use of net operating loss carryovers to offset Federal taxable income during that year.

Presented below are more detailed comparative data and discussions regarding our consolidated results of operations for the three and six months ended December 31, 2012 compared to the three and six months ended December 31, 2011. Results of operations for any period less than one year are not necessarily indicative of results of operations that may be expected for a full year.

Table of Contents***For the Three Months Ended December 31, 2012 compared to the Three Months Ended December 31, 2011***

The following table presents selected consolidated statement of operations data for the three months ended December 31, 2012 and 2011 (in thousands):

	2012		2011	
	Total	% of Sales	Total	% of Sales
Net sales	\$ 65,979	100.0%	\$ 55,370	100.0%
Cost of goods sold	54,571	82.7	46,634	84.2
Gross profit	11,408	17.3	8,736	15.8
Selling and administrative expenses	7,375	11.2	5,535	10.0
Internal research and development expenses	243	0.4	218	0.4
Restructuring/impairment charges			(59)	(0.1)
Other operating expense, net	277	0.4	123	0.2
Operating income	3,513	5.3	2,919	5.3
Total other income (expense), net	(91)	(0.1)	92	0.1
Income before provision for (benefit from) income taxes	3,422	5.2	3,011	5.4
Provision for (benefit from) income taxes	(979)	(1.5)	1,069	1.9
Net income	\$ 4,401	6.7%	\$ 1,942	3.5%

The following table presents net sales for the three months ended December 31, 2012 and 2011 (in thousands):

SEGMENT	2012		2011		% Change
	Total	% of Total	Total	% of Total	
Medical	\$ 34,804	52.8%	\$ 28,027	50.6%	24.2%
CS	14,059	21.3	12,549	22.7	12.0
DSS	21,402	32.4	18,476	33.4	15.8
Eliminations	(4,286)	(6.5)	(3,682)	(6.7)	16.4
Totals	\$ 65,979	100.0%	\$ 55,370	100.0%	19.2

The following table presents gross profit and gross profit as a percent of net sales for the three months ended December 31, 2012 and 2011 (in thousands):

SEGMENT	2012		2011	
	Total	GP%	Total	GP%
Medical	\$ 4,344	12.5%	\$ 3,883	13.9%
CS	1,428	10.2	1,306	10.4
DSS	5,636	26.3	3,547	19.2
Totals	\$ 11,408	17.3	\$ 8,736	15.8

The following table presents operating income and operating income as a percent of net sales for the three months ended December 31, 2012 and 2011 (in thousands):

Edgar Filing: SPARTON CORP - Form 10-Q

SEGMENT	2012		2011	
	Total	% of Sales	Total	% of Sales
Medical	\$ 1,803	5.2%	\$ 2,332	8.3%
CS	777	5.5	600	4.8
DSS	4,143	19.4	2,404	13.0
Other unallocated	(3,210)		(2,417)	
Totals	\$ 3,513	5.3	\$ 2,919	5.3

Table of Contents**Medical**

Medical sales in the three months ended December 31, 2012 include \$6.1 million of additional sales from the acquisition of Onyx. Excluding these fiscal year 2013 incremental sales, legacy Medical sales increased approximately \$0.7 million in the three months ended December 31, 2012 as compared with the prior year quarter. Reflected within the increase is \$5.9 million of increased sales to this business unit's largest customer due to expanded demand for its programs and additional refurbishment service revenue which began in the second half of fiscal 2012. Additionally reflected is \$0.9 million of increased sales to another customer to meet increased demand for its product in both the U.S. and Japan. Partially offsetting these increases were decreased sales to three customers totaling \$5.4 million. Decreased sales to one customer reflect the dual sourcing of certain of its programs with the Company during fiscal 2012. Decreased sales to the remaining two customers reflect these customers' disengagements during fiscal 2012. Several other customers in the aggregate accounted for the remaining sales variance. Medical sales are dependent on a small number of key strategic customers. Fenwal Blood Technologies contributed 21% and 14% of consolidated company net sales during the three months ended December 31, 2012 and 2011, respectively. Medical backlog was approximately \$67.4 million at December 31, 2012. Commercial orders, in general, may be rescheduled or cancelled without significant penalty, and, as a result, may not be a meaningful measure of future sales. A majority of the December 31, 2012 Medical backlog is currently expected to be realized in the next 12 months.

Gross profit varies from period to period and can be affected by a number of factors, including product mix, production efficiencies, capacity utilization, and costs associated with new program introduction. The gross profit percentage on Medical sales decreased to 12.5% from 13.9% for the three months ended December 31, 2012 and 2011, respectively. This decrease in margin percentage on Medical sales reflects the impact of a non-cash capitalization of profit as part of the fair value accounting for the acquired inventory of Onyx, partially offset by certain favorable product mix between the two periods. The capitalization of gross profit recognized as part of the purchase accounting for Onyx was fully recognized as additional cost of goods sold in the Company's second quarter statement of income and will not impact margin percentage in future quarters.

Selling and administrative expenses relating to the Medical segment were \$2.3 million and \$1.5 million for the three months ended December 31, 2012 and 2011, respectively. The current year quarter includes \$0.7 million of incremental expenses related to the Company's recent acquisition.

Amortization of intangible assets was \$0.3 million and \$0.1 million for the three months ended December 31, 2012 and 2011, respectively. The increase relates to amortization of customer relationships and non-compete agreements acquired as part of the Onyx transaction.

Complex Systems

Excluding an increase in intercompany sales of \$0.6 million, CS sales to external customers for the three months ended December 31, 2012 increased \$0.9 million as compared with the same quarter last year, due primarily to increased sales to two customers, partially offset by lower sales to three customers, reflecting relative demand for each of these customers' products. CS intercompany sales result primarily from the production of circuit boards that are then utilized in DSS product sales. These intercompany sales are eliminated in consolidation. CS backlog was approximately \$35.1 million at December 31, 2012. Commercial orders, in general, may be rescheduled or cancelled without significant penalty, and, as a result, may not be a meaningful measure of future sales. A majority of the December 31, 2012 CS backlog is currently expected to be realized in the next 12 months.

The gross profit percentage on CS sales remained relatively consistent at 10.2% for the three months ended December 31, 2012 compared to 10.4% for the three months ended December 31, 2011.

Selling and administrative expenses relating to the CS segment were \$0.7 million for each of the three months ended December 31, 2012 and 2011, respectively.

Defense and Security Systems

DSS sales increased approximately \$2.9 million in the three months ended December 31, 2012 as compared with the same quarter last year, reflecting increased sonobuoy sales to foreign governments, partially offset by decreased U.S. Navy sonobuoy production and engineering sales in the current year quarter. The second quarter fiscal 2013 includes approximately \$3.5 million of revenue from the U.S. Navy acceptance under waiver of the two sonobuoy lots that failed at the Navy test range in the final weeks of September 2012. The testing was conducted under suboptimal environmental conditions, which were outside of the product's design specifications. Total sales to the U.S. Navy in the three months ended December 31, 2012 and 2011 was approximately \$11.6 million and \$13.1 million, or 18% and 24%, respectively, of consolidated Company net sales for those periods. Sonobuoy sales to foreign governments were \$9.6 million and \$5.2 million in the three months ended

Edgar Filing: SPARTON CORP - Form 10-Q

December 31, 2012 and 2011, respectively. DSS backlog was approximately \$109.0 million at December 31, 2012. A majority of the December 31, 2012 DSS backlog is currently expected to be realized within the next 12 to 16 months.

Table of Contents

The gross profit percentage on DSS sales increased to 26.3% for the three months ended December 31, 2012 compared to 19.2% for the three months ended December 31, 2011. Gross profit percentage was favorably affected in the current year quarter by a significant increase in foreign sonobuoy sales and favorable product mix on U.S. Navy sales as compared to the prior year quarter.

Selling and administrative expenses relating to the DSS segment were \$1.2 million and \$0.9 million for the three months ended December 31, 2012 and 2011, respectively, primarily reflecting increased business development efforts in the current fiscal quarter.

Internal research and development expenses reflect costs incurred for the internal development of technologies for use in navigation and oil and gas exploration. These costs include salaries and related expenses, contract labor and consulting costs, materials and the cost of certain research and development specific equipment. The Company incurred \$0.2 million of internally funded research and development expenses in each of the three months ended December 31, 2012 and 2011, respectively.

Other Unallocated

Total corporate selling and administrative expenses were \$5.0 million and \$4.2 million for the three months ended December 31, 2012 and 2011, respectively, with the increase primarily reflecting professional and travel expenses relating to the pursuit of acquisitions and costs related to the Company's overall transformation of its finance organization. Of these costs, \$1.8 million was allocated to segment operations in each of these periods. Allocations of corporate selling and administrative expenses are based on the nature of the service provided and can fluctuate from period to period.

Interest expense consists of interest and fees on our outstanding debt and revolving credit facility, including amortization of financing costs. Interest expense was \$0.2 million for each of the three months ended December 31, 2012 and 2011, respectively. Fiscal 2013 was favorably impacted by the July 2012 completion of amortization of financing fees paid relating to the Company's prior revolving credit facility and the July 2012 reduction of unused line fees under that credit facility. Offsetting these favorable items was borrowings under the Company's new credit facility in fiscal 2013. See Note 6, Debt, of the Notes to Unaudited Condensed Consolidated Financial Statements in this Quarterly Report on Form 10-Q for a further discussion of debt.

The Company is responsible for income taxes within each jurisdiction in which it operates. During the three months ended December 31, 2012, the Company recognized a \$2.1 million income tax benefit from claiming a worthless stock and bad debt deduction with respect to its investments and advances to its 100% owned Canadian subsidiary, Sparton of Canada, Ltd. Excluding this discrete tax benefit, the Company recorded income tax expense of approximately \$1.1 million, or an effective rate of 32% for the three months ended December 31, 2012 compared to an income tax expense of approximately \$1.1 million, or an effective rate of approximately 36%, for the three months ended December 31, 2011. The fiscal 2013 effective rate was favorably impacted in comparison to the rate in the prior year quarter by the domestic manufacturing deduction. The use of this deduction in fiscal 2012 was limited due to the use of net operating loss carryovers to offset Federal taxable income during that year. See Note 8, Income Taxes, of the Notes to Unaudited Condensed Consolidated Financial Statements in this Quarterly Report on Form 10-Q for a further discussion of income taxes.

Due to the factors described above, the Company reported net income of \$4.4 million (\$0.43 per share, basic and diluted) for the three months ended December 31, 2012, compared to net income of \$1.9 million (\$0.19 per share, basic and diluted) for the corresponding period last year.

Table of Contents**For the Six Months Ended December 31, 2012 compared to the Six Months Ended December 31, 2011**

The following table presents selected consolidated statement of operations data for the six months ended December 31, 2012 and 2011 (in thousands):

	2012		2011		
	Total	% of Sales	Total	% of Sales	
Net sales	\$ 114,999	100.0%	\$ 107,203	100.0%	
Cost of goods sold	96,378	83.8	90,123	84.1	
Gross profit	18,621	16.2	17,080	15.9	
Selling and administrative expenses	12,847	11.2	10,946	10.2	
Internal research and development expenses	548	0.5	616	0.6	
Restructuring/impairment charges			(59)	(0.1)	
Other operating expense, net	369	0.3	269	0.2	
Operating income	4,857	4.2	5,308	5.0	
Total other income (expense), net	(34)	(0.0)	61	0.0	
Income before provision for (benefit from) income taxes	4,823	4.2	5,369	5.0	
Provision for (benefit from) income taxes	(531)	(0.5)	1,918	1.8	
Net income	\$ 5,354	4.7%	\$ 3,451	3.2%	

The following table presents net sales for the six months ended December 31, 2012 and 2011 (in thousands):

SEGMENT	2012		2011		% Change
	Total	% of Total	Total	% of Total	
Medical	\$ 62,863	54.7%	\$ 55,487	51.8%	13.3%
CS	26,406	22.9	25,109	23.4	5.2
DSS	34,608	30.1	33,763	31.5	2.5
Eliminations	(8,878)	(7.7)	(7,156)	(6.7)	24.1
Totals	\$ 114,999	100%	\$ 107,203	100.0%	7.3

The following table presents gross profit and gross profit as a percent of net sales for the six months ended December 31, 2012 and 2011 (in thousands):

SEGMENT	2012		2011	
	Total	GP%	Total	GP%
Medical	\$ 8,538	13.6%	\$ 7,497	13.5%
CS	2,524	9.6	2,394	9.5
DSS	7,559	21.8	7,189	21.3
Totals	\$ 18,621	16.2	\$ 17,080	15.9

The following table presents operating income (loss) and operating income (loss) as a percent of net sales for the six months ended December 31, 2012 and 2011 (in thousands):

Edgar Filing: SPARTON CORP - Form 10-Q

SEGMENT	2012		2011	
	Total	% of Sales	Total	% of Sales
Medical	\$ 4,425	7.0%	\$ 4,219	7.6%
CS	1,163	4.4	943	3.8
DSS	4,681	13.5	4,645	13.8
Other unallocated	(5,412)		(4,499)	
Totals	\$ 4,857	4.2	\$ 5,308	5.0

Table of Contents***Medical***

Medical sales in the six months ended December 31, 2012 include \$6.1 million of additional sales from the acquisition of Onyx. Excluding these fiscal year 2013 incremental sales, legacy Medical sales increased approximately \$1.3 million in the six months ended December 31, 2012 as compared with the prior year period. Reflected within the increase is \$9.1 million of increased sales to this business unit's largest customer due to expanded demand for its programs and additional refurbishment service revenue which began in the second half of fiscal 2012. Additionally reflected is \$2.2 million of increased sales to another customer to meet increased demand for its product in both the U.S. and Japan. Partially offsetting these increases were decreased sales to three customers totaling \$9.4 million. Decreased sales to one customer reflect the dual sourcing of certain of its programs with the Company during fiscal 2012. Decreased sales to the remaining two customers reflect these customers' disengagements during fiscal 2012. Several other customers in the aggregate accounted for the remaining sales variance. Medical sales are dependent on a small number of key strategic customers. Fenwal Blood Technologies contributed 21% and 15% of consolidated company net sales during the six months ended December 31, 2012 and 2011, respectively.

The gross profit percentage on Medical sales remained relatively consistent at 13.6% and 13.5% for the six months ended December 31, 2012 and 2011, respectively. This margin percentage on Medical sales comparison reflects certain favorable product mix between the two periods, partially offset by the impact of a non-cash capitalization of profit as part of the fair value accounting for the acquired inventory of Onyx. The capitalization of gross profit recognized as part of the purchase accounting for Onyx was fully recognized as additional cost of goods sold in the Company's second quarter statement of income and will not impact margin percentage in future quarters.

Selling and administrative expenses relating to the Medical segment were \$3.7 million and \$3.1 million for the six months ended December 31, 2012 and 2011, respectively. The current year period includes \$0.7 million of incremental expenses related to the Company's recent acquisition. The prior year period includes \$0.1 million of costs relating to changes in operational leadership in fiscal 2012.

Amortization of intangible assets was \$0.4 million and \$0.2 million for the six months ended December 31, 2012, respectively. The increase relates to amortization of customer relationships and non-compete agreements acquired as part of the Onyx transaction.

Complex Systems

Excluding an increase in intercompany sales of \$1.7 million, CS sales to external customers for the six months ended December 31, 2012 decreased \$0.4 million as compared with the same period last year, due primarily to decreased sales to three customers, offset by increased sales to two customers, reflecting relative demand for each of these customers' products. CS intercompany sales result primarily from the production of circuit boards that are then utilized in DSS product sales. These intercompany sales are eliminated in consolidation.

The gross profit percentage on CS sales remained relatively consistent at 9.6% for the six months ended December 31, 2012 compared to 9.5% for the six months ended December 31, 2011.

Selling and administrative expenses relating to the CS segment remained relatively consistent at \$1.4 million and \$1.5 million for the six months ended December 31, 2012 and 2011, respectively.

Defense and Security Systems

DSS sales increased approximately \$0.8 million in the six months ended December 31, 2012 as compared with the same period last year, reflecting increased U.S. Navy sonobuoy production and increased digital compass sales, partially offset by decreased sonobuoy sales to foreign governments in the current year period. Total sales to the U.S. Navy in the six months ended December 31, 2012 and 2011 was approximately \$23.8 million and \$19.0 million, or 21% and 18%, respectively, of consolidated Company net sales for those periods. Sonobuoy sales to foreign governments were \$9.7 million and \$14.5 million in the six months ended December 31, 2012 and 2011, respectively.

The gross profit percentage on DSS sales increased to 21.8% for the six months ended December 31, 2012 compared to 21.3% for the six months ended December 31, 2011. The period over period comparison primarily reflects favorable U.S. Navy product mix, the positive impact from increased digital compass sales, partially offset by decreased foreign sonobuoy sales in the current year period.

Table of Contents

Selling and administrative expenses relating to the DSS segment were \$2.3 million and \$1.9 million for the six months ended December 31, 2012 and 2011, respectively, primarily reflecting increased business development efforts in the current fiscal period.

Internal research and development expenses reflect costs incurred for the internal development of technologies for use in navigation and oil and gas exploration. These costs include salaries and related expenses, contract labor and consulting costs, materials and the cost of certain research and development specific equipment. The Company incurred \$0.5 million and \$0.6 million of internally funded research and development expenses in the six months ended December 31, 2012 and 2011, respectively.

Other Unallocated

Total corporate selling and administrative expenses were \$9.1 million and \$8.0 million for the six months ended December 31, 2012 and 2011, respectively, with the increase primarily reflecting professional and travel expenses relating to the pursuit of acquisitions and costs related to the Company's overall transformation of its finance organization. Of these costs, \$3.7 million and \$3.5 million was allocated to segment operations in each of these periods. Allocations of corporate selling and administrative expenses are based on the nature of the service provided and can fluctuate from period to period.

Interest expense consists of interest and fees on our outstanding debt and revolving credit facility, including amortization of financing costs. Interest expense was \$0.3 million for each of the six months ended December 31, 2012 and 2011, respectively. Fiscal 2013 was favorably impacted by the July 2012 completion of amortization of financing fees paid relating to the Company's prior revolving credit facility and the July 2012 reduction of unused line fees under that credit facility. Partially offsetting these favorable items were borrowings under the Company's new credit facility in fiscal 2013. See Note 6, Debt, of the Notes to Unaudited Condensed Consolidated Financial Statements in this Quarterly Report on Form 10-Q for a further discussion of debt.

The Company is responsible for income taxes within each jurisdiction in which it operates. During the six months ended December 31, 2012, the Company recognized a \$2.1 million income tax benefit from claiming a worthless stock and bad debt deduction with respect to its investments and advances to its 100% owned Canadian subsidiary, Sparton of Canada, Ltd. Excluding this discrete tax benefit, the Company recorded income tax expense of approximately \$1.6 million, or an effective rate of 32% for the six months ended December 31, 2012 compared to an income tax expense of approximately \$1.9 million, or an effective rate of approximately 36%, for the six months ended December 31, 2011. The fiscal 2013 effective rate was favorably impacted in comparison to the rate in the prior year quarter by the domestic manufacturing deduction. The use of this deduction in fiscal 2012 was limited due to the use of net operating loss carryovers to offset Federal taxable income during that year. See Note 8, Income Taxes, of the Notes to Unaudited Condensed Consolidated Financial Statements in this Quarterly Report on Form 10-Q for a further discussion of income taxes.

Due to the factors described above, the Company reported net income of \$5.4 million (\$0.53 per share, basic and \$0.52 per share, diluted) for the six months ended December 31, 2012, compared to net income of \$3.5 million (\$0.34 per share, basic and \$0.33 per share, diluted) for the corresponding period last year.

Table of Contents

Liquidity and Capital Resources

On November 15, 2012, the Company replaced its previous revolving line-of-credit facility with a new \$65 million credit facility with BMO Harris Bank N.A., consisting of a \$35 million revolving line-of-credit facility (the Revolving Credit) to support the Company's working capital needs and other general corporate purposes, and a \$30 million acquisition loan commitment (the Acquisition Facility) and together with the Revolving Credit, the Credit Facility) to finance permitted acquisitions, including the acquisition of Onyx. The Credit Facility expires on November 15, 2017, is secured by substantially all assets of the Company and provides for up to an additional \$35 million in uncommitted loans available for additional Revolving Credit loans or Acquisition loans. As a condition of the Credit Facility, the Company is subject to certain customary covenants, which it was in compliance with at December 31, 2012. The Company had \$14.0 million of borrowings drawn against the Credit Facility at December 31, 2012. The Company also has approximately \$1.6 million of industrial revenue bonds outstanding at December 31, 2012. See Note 6, Debt, of the Notes to Unaudited Condensed Consolidated Financial Statements in this Quarterly Report on Form 10-Q for a further discussion of the Company's debt.

Certain of the Company's DSS contracts allow for billings to occur when certain milestones under the applicable program are reached, independent of the amount shipped by Sparton as of such date. These advance billings reduce the amount of cash that would otherwise be required during the performance of these contracts. As of December 31, 2012 and June 30, 2012, \$20.7 million and \$25.8 million, respectively, of billings in excess of costs were received.

The Company currently expects to meet its liquidity needs through a combination of sources including, but not limited to, operations, existing cash balances, its revolving line-of-credit, anticipated continuation of advance billings on certain DSS contracts and improvement in inventory management. With the above sources providing the expected cash flows, the Company currently believes that it will have sufficient liquidity for its anticipated needs over the next 12 months, but no assurances regarding liquidity can be made.

Operating activities used \$8.9 million and provided \$7.7 million of net cash flows in six months ended December 31, 2012 and 2011, respectively. Excluding changes in working capital, operating activities provided \$8.3 million and \$6.8 million in the first six months of fiscal 2013 and 2012, respectively, reflecting the Company's relative operating performance during those periods. Working capital used \$17.2 million and provided \$0.9 million of net cash flows in the six months ended December 31, 2012 and 2011, respectively. Working capital related cash flows in the first six months of fiscal 2013 primarily reflect increased accounts receivable, inventory and other assets, reduced accounts payable and accrued expenses and funding of production related to U.S. Navy contracts during the year in excess of advance billings received, partially offset by decreased accounts receivable. Working capital related cash flows in the first six months of fiscal 2012 primarily reflect the collection of advance billings related to U.S. Navy contracts during the quarter in excess of the funding of production under those contracts, partially offset by increased accounts receivable, increased prepaid expenses and other assets and reduced accounts payable and accrued liabilities.

Cash flows used in investing activities in six months ended December 31, 2012 and 2011 totaled \$45.4 million and \$0.2 million, respectively. The six months ended December 31, 2012 reflect the \$43.25 million acquisition of Onyx. The acquisition, which is subject to certain post-closing adjustments, was funded through the use of Company cash and borrowings under the Company's new credit facility. The Company has recognized an additional \$2.19 million as additional accrued consideration on its balance sheet, which is expected to be settled with the seller during the Company's fiscal 2013 third quarter. The six months ended December 31, 2012 reflects the utilization of \$0.5 million as cash collateral for certain letters of credit outstanding issued by PNC Bank, National Association. The Company intends to have these letters of credit issued by BMO Harris Bank N.A. under the Credit Facility during the Company's third quarter of fiscal 2013, eliminating the need for this cash collateral. The six months ended December 31, 2011 reflects the Company's sale of its investment in Cybernet Systems Corporation for approximately \$1.8 million. Capital expenditures for the six months ended December 31, 2012 and 2011 were approximately \$1.6 million and \$1.9 million, respectively. Included in capital expenditures for these periods \$0.1 million and \$0.8 million, respectively, related to the implementation of a new enterprise resource planning system put into service in the Company's fiscal 2013 second quarter.

Financing activities provided \$13.4 million and used \$1.5 million in the six months ended December 31, 2012 and 2011, respectively. The six months ended December 31, 2012 reflect \$14.0 million of net borrowing under the Company's new credit facility, the payment of \$0.4 million of financing fees and the use of cash of \$0.2 million to satisfy income tax withholding requirements in relation to the vesting of executives restricted stock in exchange for the surrender of a portion of the vesting shares. Each of the six months ended December 31, 2012 and 2011 also reflect repayments on the Company's outstanding industrial revenue bonds with the state of Ohio of less than \$0.1 million and receipts of approximately \$0.1 million from the exercise of stock options.

Table of Contents
Commitments and Contingencies***Environmental Remediation***

Sparton has been involved with ongoing environmental remediation since the early 1980 s related to one of its former manufacturing facilities, located in Albuquerque, New Mexico (Coors Road). Although the Company entered into a long-term lease of the Coors Road property that was accounted for as a sale of property during fiscal 2010, it remains responsible for the remediation obligations related to its past operation of this facility. At December 31, 2012, Sparton had accrued approximately \$3.4 million as its estimate of the remaining minimum future undiscounted financial liability with respect to this matter, of which approximately \$0.4 million is classified as a current liability and included on the balance sheet in other accrued expenses. The Company s minimum cost estimate is based upon existing technology and excludes certain legal costs, which are expensed as incurred. The Company s estimate includes equipment and operating and maintenance costs for onsite and offsite pump and treat containment systems, as well as continued onsite and offsite monitoring. It also includes periodic reporting requirements.

In fiscal 2003, Sparton reached an agreement with the United States Department of Energy (DOE) and others to recover certain remediation costs. Under the settlement terms, Sparton received cash and obtained some degree of risk protection as the DOE agreed to reimburse Sparton for 37.5% of certain future environmental expenses in excess of \$8.4 million incurred from the date of settlement, if any, of which approximately \$4.4 million has been expended as of December 31, 2012 toward the \$8.4 million threshold. Uncertainties associated with environmental remediation contingencies are pervasive and often result in wide ranges of reasonably possible outcomes. Estimates developed in the early stages of remediation can vary significantly. Normally a finite estimate of cost does not become fixed and determinable at a specific point in time. Rather, the costs associated with environmental remediation become estimable over a continuum of events and activities that help to frame and define a liability. Factors which cause uncertainties for the Company include, but are not limited to, the effectiveness of the current work plans in achieving targeted results and proposals of regulatory agencies for desired methods and outcomes. It is possible that cash flows and results of operations could be materially affected by the impact of changes associated with the ultimate resolution of this contingency. At December 31, 2012, the Company estimates that it is reasonably possible, but not probable, that future environmental remediation costs associated with the Company s past operations at the Coors Road property, in excess of amounts already recorded and net of DOE reimbursement, could be up to \$2.4 million before income taxes over the next eighteen years.

The Company and its subsidiaries are also involved in certain existing compliance issues with the EPA and various state agencies, including being named as a potentially responsible party at several sites. Potentially responsible parties (PRP s) can be held jointly and severally liable for the clean-up costs at any specific site. The Company s past experience, however, has indicated that when it has contributed relatively small amounts of materials or waste to a specific site relative to other PRPs, its ultimate share of any clean-up costs has been minor. Based upon available information, the Company believes it has contributed only small amounts to those sites in which it is currently viewed as a PRP and that reasonably possible losses related to these compliance issues are immaterial.

U.S. Government Audits

Federal government agencies, including the Defense Contract Audit Agency (DCAA) and the Defense Contract Management Agency (DCMA), routinely audit and investigate government contracts and government contractors administrative processes and systems. These agencies review the Company s performance on contracts, pricing practices, cost structure and compliance with applicable laws, regulations and standards. They also review the adequacy of the Company s internal control systems and policies, including the Company s purchasing, accounting, estimating, compensation and management information processes and systems.

The Company responded in November 2011 to DCAA review comments received in the first quarter of fiscal 2012 regarding corrective actions to improve the reliability for accumulating costs under government contracts. As a result, DCMA has determined our cost accounting system is currently adequate and the Company remains eligible to receive cost reimbursable contracts from the U.S. Government. While the Company s corrective actions remain open for further review, the Company remains confident that formal resolution of DCAA cost accounting practices findings will not have a material adverse impact on the Company s financial results.

Table of Contents

Other

In addition to the foregoing, from time to time, the Company is involved in various legal proceedings relating to claims arising in the ordinary course of business. The Company is not currently a party to any other such legal proceedings, the adverse outcome to which, individually or in the aggregate, is expected to have a material adverse effect on our business, financial condition or results of operations.

Contractual Obligations and Off-Balance Sheet Arrangements

Information regarding the Company's long-term debt obligations, environmental liability payments, operating lease payments, and other commitments is provided in Part II, Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, of the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2012. As of June 30, 2012, there were \$27.3 million of non-cancelable purchase orders outstanding, \$1.8 million of debt and a liability related to advance billings on customer contracts of \$25.8 million. As of December 31, 2012, the non-cancelable purchase orders outstanding has increased to \$38.0 million, debt increased to \$15.7 million (as discussed below) and the liability related to advanced billings has decreased to \$20.7 million. Other than as noted above, there have been no material changes in the nature or amount of the Company's contractual obligations since June 30, 2012.

On November 15, 2012, the Company entered into a new revolving credit agreement, under which \$14.0 million was borrowed at December 31, 2012. See Note 6, Debt, of the Notes to Unaudited Condensed Consolidated Financial Statements in this Quarterly Report on Form 10-Q for a discussion of this new debt facility.

Critical Accounting Policies

Our financial statements are prepared in conformity with GAAP and require us to select appropriate accounting policies. The assumptions and judgments we use in applying our accounting policies have a significant impact on our reported amounts of assets, liabilities, revenue and expenses. While we believe that the assumptions and judgments used in our estimates are reasonable, actual results may differ from these estimates under different assumptions or conditions.

We have identified the most critical accounting policies upon which our financial status depends. The critical policies were determined by considering accounting policies that involve the most complex or subjective decisions or assessments. We also have other policies considered key accounting policies; however, these policies do not meet the definition of critical accounting policies because they do not generally require us to make estimates or judgments that are complex or subjective. Our critical accounting policies include the following:

Environmental contingencies

Government contract cost estimates

Commercial inventory valuation

Allowance for probable losses on receivables

Pension obligations

Business combinations

Valuation of property, plant and equipment

Goodwill and intangible assets

Income taxes

Stock-based compensation

There have been no significant changes to our critical accounting policies that are described in Part II, Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations section of our Annual Report on Form 10-K for the year ended June 30, 2012.

New Accounting Pronouncements

See Note 14, New Accounting Standards, of the Notes to Unaudited Condensed Consolidated Financial Statements in this Quarterly Report on Form 10-Q for a discussion of new accounting pronouncements.

Table of Contents

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

The Company manufactures its products in the United States and Vietnam. Sales are to the U.S. as well as foreign markets. The Company is potentially subject to foreign currency exchange rate risk relating to intercompany activity and balances and to receipts from customers and payments to suppliers in foreign currencies. Also, adjustments related to the translation of the Company's Vietnamese financial statements into U.S. dollars are included in current earnings. As a result, the Company's financial results could be affected by factors such as changes in foreign currency exchange rates or economic conditions in the domestic and foreign markets in which the Company operates. However, minimal third party receivables and payables are denominated in foreign currency and the related market risk exposure is considered to be immaterial.

The Company's revolving credit line, when drawn upon, is subject to future interest rate fluctuations which could potentially have a negative impact on cash flows of the Company. The Company had \$14.0 million outstanding under its credit facility at December 31, 2012. A prospective increase of 100 basis points in the interest rate applicable to the Company's outstanding borrowings under its credit facility would result in an increase of approximately \$0.1 million in our annual interest expense. The Company is not party to any currency exchange or interest rate protection agreements as of December 31, 2012.

Item 4. Controls and Procedures.

Each of our Chief Executive Officer and Chief Financial Officer has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities and Exchange Act of 1934) as of the end of the period covered by this quarterly report. Based on such evaluation, such officers have concluded that, as of the end of the period covered by this quarterly report, our disclosure controls and procedures are effective.

There have been no changes in our internal controls over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended December 31, 2012 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

See Management's Discussion and Analysis of Financial Condition and Results of Operations - Commitments and Contingencies of this report.

In addition to the above, from time to time, we are involved in various legal proceedings relating to claims arising in the ordinary course of business. We are not currently a party to any such legal proceedings, the outcome of which, individually or in the aggregate, is expected to have a material adverse effect on our business, financial condition or results of operations.

Item 1A. Risk Factors.

You should carefully consider the risks and uncertainties described in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended June 30, 2012 and the other information in our subsequent filings with the SEC, including this Quarterly Report on Form 10-Q. Our business, financial condition, results of operations and stock price could be materially adversely affected by any of these risks. The risks described in our Annual Report on Form 10-K are not the only ones we face. Additional risks and uncertainties that are currently unknown to us or that we currently consider to be immaterial may also impair our business or adversely affect our financial condition, results of operations and stock price.

Table of Contents**Item 6. Exhibits.**

Exhibit Number	Description
3.1	Second Amended Articles of Incorporation of the Registrant, incorporated herein by reference from the Registrant's Proxy Statement on Form DEF 14A filed with the SEC on September 21, 2010.
3.2	Amended and Restated Code of Regulations of the Registrant, incorporated herein by reference from the Registrant's Proxy Statement on Form DEF 14A filed with the SEC on September 21, 2010.
3.3	Amendment to Amended and Restated Code of Regulations of the Registrant, incorporated herein by reference from exhibit 99.1 to the Registrant's Current Report on Form 8-K filed with the SEC on October 26, 2012.
10.1	Unit Purchase Agreement dated November 2, 2012, between Everett Smith Group, Ltd. and Sparton Onyx, LLC, incorporated herein by reference from the Registrant's Form 8-K filed with the SEC on November 7, 2012.
10.2	Credit Agreement dated November 15, 2012, entered into between B.M.O. Harris Bank, N.A., and the Borrowers, incorporated herein by reference from the Registrant's Form 8-K filed with the SEC on November 19, 2012.
10.3	Employment Agreement between the Registrant and Mark Schlei, incorporated herein by reference from the Registrant's Form 8-K filed with the SEC on November 13, 2012.
31.1*	Chief Executive Officer certification under Section 302 of the Sarbanes-Oxley Act of 2002.
31.2*	Chief Financial Officer certification under Section 302 of the Sarbanes-Oxley Act of 2002.
32.1*	Chief Executive Officer and Chief Financial Officer certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS**	XBRL Instance Document
101.SCH**	XBRL Taxonomy Extension Schema Document
101.CAL**	XBRL Taxonomy Calculation Linkbase Document
101.DEF**	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB**	XBRL Taxonomy Extension Label Linkbase Document
101.PRE**	XBRL Taxonomy Extension Presentation Linkbase Document

Indicates management contract or compensatory arrangement.

* Filed herewith.

** XBRL (Extensible Business Reporting Language) information is deemed not filed or part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.

Table of Contents

SIGNATURES

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

Sparton Corporation

Date: February 5, 2013

By: /s/ CARY B. WOOD
Cary B. Wood
President and Chief Executive Officer
(Principal Executive Officer)

Date: February 5, 2013

By: /s/ MARK SCHLEI
Mark Schlei
Senior Vice President and Chief Financial Officer
(Principal Financial Officer)

37