KEY TRONIC CORP
Form 10-Q
May 14, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

FOR THE PERIOD ENDED MARCH 31, 2012

OR

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

FOR THE PERIOD FROM TO .

Commission File Number 0-11559

KEY TRONIC CORPORATION

(Exact name of registrant as specified in its charter)

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

N. 4424 Sullivan Road

Spokane Valley, Washington 99216

(509) 928-8000

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

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

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

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

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

As of April 28, 2012, 10,466,688 shares of common stock, no par value (the only class of common stock), were outstanding.

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* Items are not applicable

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

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PART I: FINANCIAL INFORMATION

Item 1: Financial Statements

KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Unaudited, in thousands)

	March 31, 2012	July 2, 2011
Assets		
Current assets:		
Cash and cash equivalents	$ 488	$ 1,232
Trade receivables, net (allowance for doubtful accounts of $0 and $111)	59,694	40,350
Inventories	53,893	41,554
Deferred income tax asset	3,965	3,900
Other	4,892	4,549
Total current assets	122,932	91,585
Property, plant and equipment net	16,862	14,917
Other assets:		
Deferred income tax asset	10,418	4,219
Other	934	1,643
Total other assets	11,352	5,862
Total assets	$ 151,146	$ 112,364
Liabilities and shareholders equity		
Current liabilities:		
Accounts payable	$ 40,972	$ 26,149
Accrued compensation and vacation	5,353	4,436
Current portion of other long-term obligations	718	761
Other	2,565	1,932
Total current liabilities	49,608	33,278
Long-term liabilities:		
Revolving loan	16,228	6,000
Deferred income tax liability	4,847	1,542
Other long-term obligations	5,807	3,521
Total long-term liabilities	26,882	11,063
Total liabilities	76,490	44,341
Commitments and contingencies (Note 7)		
Shareholders equity:		
Common stock, no par value shares authorized 25,000; issued and outstanding 10,453 and 10,399 shares, respectively	41,622	41,014
Retained earnings	33,084	25,269

Accumulated other comprehensive (loss) income		(50)		1,740
Total shareholders equity		74,656		68,023
Total liabilities and shareholders equity	$	151,146	$	112,364

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited, in thousands, except per share amounts)

	Three Months Ended		Nine Months Ended	
	March 31, 2012	April 2, 2011	March 31, 2012	April 2, 2011
Net sales	$ 95,527	$ 63,424	$ 249,742	$ 187,802
Cost of sales	86,803	59,195	229,145	172,157
Gross profit on sales	8,724	4,229	20,597	15,645
Research, development and engineering expenses	1,153	919	3,266	2,794
Selling, general and administrative expenses	2,879	2,373	8,229	7,575
Income from operations	4,692	937	9,102	5,276
Interest expense	130	172	357	319
Income before income taxes	4,562	765	8,745	4,957
Income tax provision	1,168	41	930	758
Net income	$ 3,394	$ 724	$ 7,815	$ 4,199
Net income per share Basic	$ 0.32	$ 0.07	$ 0.75	$ 0.41
Weighted average shares outstanding Basic	10,447	10,353	10,437	10,332
Net income per share Diluted	$ 0.32	$ 0.07	$ 0.74	$ 0.40
Weighted average shares outstanding Diluted	10,762	10,436	10,517	10,420

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited, in thousands)

	Three Months Ended		Nine Months Ended	
	March 31, 2012	**April 2, 2011**	**March 31, 2012**	**April 2, 2011**
Comprehensive income:				
Net income	$ 3,394	$ 724	$ 7,815	$ 4,199
Other comprehensive income:				
Unrealized gain (loss) on foreign exchange contracts, net of tax	2,301	692	(1,790)	1,775
Comprehensive income	$ 5,695	$ 1,416	$ 6,025	$ 5,974

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited, in thousands)

	Nine Months Ended	
	March 31, 2012	**April 2, 2011**
Increase (decrease) in cash and cash equivalents:		
Cash flows from operating activities:		
Net income	$ 7,815	$ 4,199
Adjustments to reconcile net income to cash used in operating activities:		
Depreciation and amortization	1,725	1,640
Accretion of deferred gain on sale of building		(39)
Provision for obsolete inventory	692	210
Provision for warranty	60	139
(Recovery of) Provision for doubtful accounts	(91)	15
Loss (Gain) on disposal of assets	5	(12)
Share-based compensation expense	461	378
Deferred income taxes	496	589
Changes in operating assets and liabilities:		
Trade receivables	(19,253)	(7,724)
Inventories	(13,031)	(5,819)
Other assets	(1,527)	(2,316)
Accounts payable	14,824	(1,231)
Accrued compensation and vacation	845	(918)
Other liabilities	66	(449)
Cash used in operating activities	(6,913)	(11,338)
Cash flows from investing activities:		
Purchase of property and equipment	(3,627)	(3,595)
Proceeds from sale of fixed assets	9	15
Proceeds from life insurance		113
Cash used in investing activities	(3,618)	(3,467)
Cash flows from financing activities:		
Payment of financing costs	(75)	(50)
Proceeds from long term debt		2,244
Principal payments on long term debt	(513)	(84)
Borrowings under revolving credit agreement	88,400	82,791
Repayment of revolving credit agreement	(78,172)	(70,607)
Proceeds from exercise of stock options	147	370
Cash provided by financing activities	9,787	14,664
Net decrease in cash and cash equivalents	(744)	(141)
Cash and cash equivalents, beginning of period	1,232	770
Cash and cash equivalents, end of period	$ 488	$ 629
Supplemental cash flow information:		
Interest payments	$ 299	$ 422

Income tax payments, net of refunds	$ 493	$ 355

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

(Unaudited, in thousands)

	Shares	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders Equity
Balances, July 2, 2011	10,399	$ 41,014	$ 25,269	$ 1,740	$ 68,023
Net income			7,815		7,815
Unrealized loss on foreign exchange contracts, net				(1,790)	(1,790)
Exercise of stock options	54	147			147
Stock-based compensation		461			461
Balances, March 31, 2012	10,453	$ 41,622	$ 33,084	$ (50)	$ 74,656

See accompanying notes to consolidated financial statements.

KEY TRONIC CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

The consolidated financial statements included herein have been prepared by Key Tronic Corporation and subsidiaries (the Company) pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in our annual consolidated financial statements have been condensed or omitted. The year-end condensed consolidated balance sheet information was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. The financial statements reflect all normal and recurring adjustments which, in the opinion of management, are necessary for a fair presentation of the financial position, results of operations and cash flows for the interim periods presented. The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the reported amounts of revenues and expenses during the reporting period. The results of operations for the periods presented are not necessarily indicative of the results to be expected for the full year. The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the financial statements and notes included in the Company s Annual Report on Form 10-K for the fiscal year ended July 2, 2011.

The Company s reporting period is a 52/53 week fiscal year ending on the Saturday closest to June 30. The three and nine month periods ended March 31, 2012 and April 2, 2011 were 13 week and 39 week periods, respectively. Fiscal year 2012 will end on June 30, 2012 which is a 52 week year, and fiscal year 2011 which ended on July 2, 2011, was also a 52 week year.

2. Significant Accounting Policies

Reclassifications

As discussed in Note 5, in the first quarter fiscal year 2012 financial statements the Company reclassified certain deferred tax assets and liabilities on its July 2, 2011 balance sheet. The reclassification was not material to the July 2, 2011 financial statements.

Income Taxes

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

We utilize a two-step approach to recognizing and measuring uncertain tax positions. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount which is more than 50% likely of being realized upon ultimate settlement. We consider many factors when evaluating and estimating our tax positions and tax benefits, which may require periodic adjustments based on new assessments and changes in estimates and which may not accurately forecast actual outcomes. Our policy is to recognize interest and penalties related to the underpayment of income taxes as a component of income tax expense. To date, we have not incurred charges for interest or penalties in relation to the underpayment of income taxes. The tax years 1993 through the present remain open to examination by the major U.S. taxing jurisdictions to which we are subject. Refer to Note 5 for further discussions.

Earnings Per Common Share

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

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Share-based Compensation

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

On October 21, 2010, the Company obtained shareholder approval of the 2010 Incentive Plan at the Annual Shareholder Meeting. As a result, the Company replaced the cash-settlement feature with a net-share-settlement feature for the SARs granted during the fourth quarter of fiscal 2010. Therefore, the awards were reclassified from liability awards to equity awards effective October 21, 2010 at a weighted average fair value of $2.89.

On July 27, 2011, the Company granted 184,666 SARs under the 2010 Incentive Plan to certain key employees and outside directors at a strike price of $4.40 and a grant date weighted average fair market value of $2.20. On January 26, 2012, the Company granted 32,000 SARs under the 2010 Incentive Plan to certain key employees and outside directors at a strike price of $6.30 and a grant date weighted average fair market value of $3.08. In addition to service conditions, these SARs contain a performance condition. The additional performance condition is based upon the achievement of Return on Invested Capital (ROIC) goals relative to a peer group. All awards with performance conditions are measured over the vesting period and are charged to compensation expense over the requisite service period based on the number of shares expected to vest. The SARs cliff vest after a three-year period from date of grant and expire five years from date of grant.

The grant date fair value for the awards granted during the first nine months of fiscal year 2012 were estimated using the Black Scholes option valuation method with the following weighted average assumptions on grant date:

	January 26, 2012	**July 27, 2011**
Expected dividend yield	0.00%	0.00%
Risk free interest rate	0.52%	1.16%
Expected volatility	64.90%	65.50%
Expected life	4.00	4.00

Total share-based compensation expense recognized during the three and nine months ended March 31, 2012 and April 2, 2011 was as follows (in thousands):

	Three Months Ended		**Nine Months Ended**	
	March 31, 2012	**April 2, 2011**	**March 31, 2012**	**April 2, 2011**
Stock Appreciation Rights	$ 161	$ 122	$ 461	$ 378

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As of March 31, 2012 total unrecognized compensation expense related to unvested share-based compensation arrangements was approximately $0.9 million. This expense is expected to be recognized over a weighted average period of 1.67 years.

Options to purchase 6,667 shares of common stock were exercised during the three months ended March 31, 2012 and 7,000 options to purchase shares of common stock were exercised during the three months ended April 2, 2011, with an immaterial amount of intrinsic value for each of the periods presented. Options to purchase 54,167 and 91,133 shares of common stock were exercised during the nine months ended March 31, 2012 and April 2, 2011, respectively, with an immaterial amount of intrinsic value for each of the periods presented.

Recently Issued Accounting Standards

In May 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs (ASU 2011-04). ASU 2011-04 amends Accounting Standards Codification (ASC) Topic 820, *Fair Value Measurements* (ASC 820) by: (1) clarifying that the highest-and-best-use and valuation-premise concepts only apply to measuring the fair value of non-financial assets; (2) allowing a reporting entity to measure the fair value of the net asset or net liability position in a manner consistent with how market participants would price the net risk position, if certain criteria are met; (3) providing a framework for considering whether a premium or discount can be applied in a fair value measurement; (4) providing that the fair value of an instrument classified in a reporting entity s shareholders equity is estimated from the perspective of a market participant that holds the identical item as an asset; and (5) expanding the qualitative and quantitative fair value disclosure requirements. The expanded disclosures include, for Level 3 items, a description of the valuation process and a narrative description of the sensitivity of the fair value to changes in unobservable inputs and interrelationships between those inputs if a change in those inputs would result in a significantly different fair value measurement. ASU 2011-04 also requires disclosures about the highest-and-best-use of a non-financial asset when this use differs from the asset s current use and the reasons for such a difference. In addition, this ASU amends Accounting Standards Codification 820, *Fair Value Measurements*, to require disclosures to include any transfers between Level 1 and Level 2 of the fair value hierarchy. These amendments are effective during interim and annual periods beginning after December 15, 2011. The adoption of the amendments of ASU 2011-04 did not have a material impact on the Company s consolidated financial statements.

In June 2011, the FASB issued Accounting Standards Update 2011-05, *Presentation of Comprehensive Income* (ASU 2011-05). ASU 2011-05 requires entities to report components of comprehensive income in either (1) a continuous statement of comprehensive income or (2) two separate but consecutive statements. Under the two-statement approach, the first statement would include components of net income, and the second statement would include components of other comprehensive income. This ASU does not change the items that must be reported in other comprehensive income. These provisions are effective for fiscal years beginning after December 15, 2011 and for interim periods within those fiscal years; however, early adoption is permitted. The provisions of ASU 2011-05, when adopted, are not expected to have a material impact on the Company s consolidated financial statements.

In December 2011, the FASB issued Accounting Standards Update 2011-12, *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income* in Accounting Standards Update 2011-05. ASU 2011-12 defers only those changes in ASU 2011-05 that relate to the presentation of reclassification adjustments. The Board has reinstated the requirements for the presentation of reclassifications out of accumulated other comprehensive income that were in place before the issuance of Update 2011-05. The amendments of ASU 2011-12 are not expected to have a material impact on the Company s consolidated financial statements.

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

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3. Inventories

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

	March 31, 2012	July 2, 2011
Finished goods	$ 6,445	$ 5,660
Work-in-process	6,398	4,821
Raw materials and supplies	41,050	31,073
	$ 53,893	$ 41,554

4. Long-Term Debt

Note Payable Bank

On October 15, 2010, the Company entered into an amended credit agreement with Wells Fargo Bank, N.A. thereby increasing its revolving line of credit facility for up to $30.0 million. On January 30, 2012, the Company entered into a second amendment to the credit agreement extending the term to October 15, 2016. The agreement specifies that the proceeds of the revolving line of credit be used primarily for working capital and general corporate purposes of the Company and its subsidiaries. Borrowings under this revolving line of credit bear interest at either a Base Rate or a Fixed Rate , as elected by the Company. The base rate is the higher of the Wells Fargo Bank prime rate, daily one month London Interbank Offered Rate (LIBOR) plus 1.5%, or the Federal Funds rate plus 1.5%. The fixed rate is LIBOR plus 2.1% or LIBOR plus 2.5% depending on the level of the Company s trailing four quarters Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). The revolving line of credit is secured by substantially all of the assets of the Company.

The Company must comply with certain financial covenants, including a cash flow leverage ratio and a trading ratio. The credit agreement requires the Company to maintain a minimum profit threshold, limits the maximum operating lease expenditures and restricts the Company from declaring or paying dividends in cash or stock. The Company is in compliance with all financial covenants for all periods presented.

As of March 31, 2012, the Company had availability to borrow an additional $13.8 million under the line of credit. The outstanding balance under the credit facility was $16.2 million as of March 31, 2012 and the interest rate on the outstanding balance was in the range of 2.35% - 3.25%. As of July 2, 2011, the outstanding balance under the credit facility was $6.0 million and the interest rate on the outstanding balance was 2.48%.

5. Income Taxes

The Company has a domestic net operating loss (NOL) and tax credit carryforwards of approximately $6.2 million and $7.1 million, respectively, as of March 31, 2012. In accordance with ASC 740, *Income Taxes*, management assesses the Company s recent operating results and estimated future taxable income. Based on the Company s continued and increased profitability and estimated future repatriation of earnings from foreign subsidiaries, the Company believes it is more likely than not that the NOLs and a majority of the tax credits will be fully utilized prior to their expiration. The Company has a valuation allowance of approximately $0.5 million related to certain research and development tax credits at March 31, 2012 because those credits may expire prior to utilization.

The Company expects to repatriate a portion of its foreign earnings based on increased sales growth driving additional capital requirements domestically, cash requirements for potential acquisitions and to implement certain tax strategies. The Company currently expects to repatriate approximately $8.8 million of foreign earnings in the future. As such, these earnings would be recognized in the United States, and the Company would be subject to U.S. federal income taxes and potential withholding taxes in foreign jurisdictions. Both the domestic tax and estimated withholding tax of expected repatriation of foreign earnings have been recorded as part of deferred taxes as of March 31, 2012. All other unremitted foreign earnings are expected to remain permanently reinvested for planned fixed assets purchases in foreign locations.

The Company has a wholly owned foreign subsidiary in Mexico that utilizes certain tax credits related to production assets that currently offset all of the income tax liabilities under general Mexican income tax law. However, the Company is subject to a Mexican business flat tax called Impuesto Empresarial a Tasa Unica (IETU). The Company anticipates that it will be taxable under IETU for the foreseeable future based on projected assets used in its operations. The effect of IETU and an associated presidential decree has been included in the effective tax rate for the three and nine months ended March 31, 2012.

The Company is required to pay taxes in China on its statutory foreign profits. Its subsidiary in China had statutory profits during the three and nine months ended March 31, 2012 and it is anticipated that the Chinese subsidiary will utilize the remainder of its NOL carryforward during the fiscal year ending June 30, 2012. Accordingly, there is no valuation allowance related to the Chinese NOL.

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

	Three Months Ended	
	March 31, 2012	**April 2, 2011**
Federal income tax expense at statutory rate	$ 1,532	$ 260
Foreign earnings taxed at lower rates	(83)	(182)
Effect of foreign currency rate changes	81	
Recognition of tax credits	(191)	(200)
Change in valuation allowance	(445)	15
Other	274	148
Income tax provision	$ 1,168	$ 41

	Nine Months Ended	
	March 31, 2012	**April 2, 2011**
Federal income tax expense at statutory rate	$ 2,973	$ 1,685
Foreign earnings taxed at lower rates	(357)	(360)
Effect of foreign currency rate changes	(70)	
Recognition of tax credits	(1,660)	(200)
Change in valuation allowance	(262)	(348)
Other	306	(19)
Income tax provision	$ 930	$ 758

During the fourth quarter of the year ended July 2, 2011, the Company recorded an unrecognized tax benefit of approximately $0.8 million which is related to certain R&D tax credits generated in 2010 and prior years. In the fourth quarter of 2011, a second and distinct unit of account was identified for potential additional R&D credits and the Company initiated a study to analyze the relevant case law and the specific facts and circumstances in this area. During the quarters ended December 31, 2011 and March 31, 2012, the Company recognized an additional $4.0 million and $0.4 million, respectively, of additional tax credits based upon the updated results of this study. ASC 740 requires the Company to recognize in its financial statements uncertainties in tax positions taken that may not be sustained upon examination by the taxing authorities. For the additional R&D tax credits recorded during these quarters, the Company also recorded $2.2 million of additional unrecognized tax benefits based upon its assessment under ASC 740. The Company accounted for these credits and the related net unrecognized tax benefits as a change in estimate and as a discrete item in fiscal year 2012.

The July 2, 2011 balance sheet in the accompanying financial statements includes two reclassifications that were not reflected in the July 2, 2011 Form 10-K. The reclassifications decreased the short term deferred tax asset by approximately $0.6 million with a corresponding decrease in the current portion of the deferred tax liability. There was also a reclassification to decrease the long term portion of the deferred tax asset by approximately $3.6 million with a corresponding decrease in the deferred tax liability. These balance sheet reclassifications related to the netting of the deferred tax accounts within the same tax jurisdiction and did not impact the Company s debt covenants, working capital, cash flows or income statement accounts and were not material to the July 2, 2011 consolidated financial statements.

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6. Earnings Per Share

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

	Three Months Ended (in thousands, except per share information)	
	March 31, 2012	April 2, 2011
Net income	$ 3,394	$ 724
Weighted average shares outstanding basic	10,447	10,353
Effect of dilutive common stock options	315	83
Weighted average shares outstanding diluted	10,762	10,436
Earnings per share basic	$ 0.32	$ 0.07
Earnings per share diluted	$ 0.32	$ 0.07
Antidilutive options not included in diluted earnings per share		541

	Nine Months Ended (in thousands, except per share information)	
	March 31, 2012	April 2, 2011
Net income	$ 7,815	$ 4,199
Weighted average shares outstanding basic	10,437	10,332
Effect of dilutive common stock options	80	88
Weighted average shares outstanding diluted	10,517	10,420
Earnings per share basic	$ 0.75	$ 0.41
Earnings per share diluted	$ 0.74	$ 0.40
Antidilutive options not included in diluted earnings per share	554	541

7. Commitments and Contingencies

Purchase Commitments

The Company had no material firm commitments to contractors and suppliers for capital expenditures at March 31, 2012.

Leases

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

Warranties

The Company provides warranties on certain product sales. Allowances for estimated warranty costs are recorded during the period of sale. The determination of such allowances requires the Company to make estimates of product return rates and expected costs to repair or to replace the products under warranty. If actual return rates and/or repair and replacement costs differ significantly from management s estimates, adjustments to recognize additional cost of sales may be required in future periods. The Company s warranty reserve was approximately $15,000 and $10,000 as of March 31, 2012 and July 2, 2011, respectively.

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8. Fair Value Measurements

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

The following table summarizes the fair values of assets/(liabilities) of the Company s derivatives that are required to be measured on a recurring basis as of March 31, 2012 and July 2, 2011 (in thousands):

	March 31, 2012			
	Level 1	Level 2	Level 3	Total Fair Value
Financial Assets:				
Foreign currency forward contracts	$	$ 813	$	$ 813
Financial Liabilities:				
Foreign currency forward contracts	$	$ (884)	$	$ (884)

	July 2, 2011			
	Level 1	Level 2	Level 3	Total Fair Value
Financial Assets:				
Foreign currency forward contracts	$	$ 2,723	$	$ 2,723
Financial Liabilities:				
Foreign currency forward contracts	$	$ (82)	$	$ (82)

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

The carrying values of cash and cash equivalents, accounts receivable and current liabilities reflected on the balance sheets at March 31, 2012 and July 2, 2011, reasonably approximate their fair value. The Company s long-term debt primarily consists of a revolving line of credit. Borrowings under this revolving line of credit bear interest at the higher of Wells Fargo Bank prime rate, daily one month London Interbank Offered Rate (LIBOR) plus 1.5% to 2.5%, or the Federal Funds rate plus 1.5%. Each of these rates is a variable floating rate dependent upon current market conditions and the Company s current credit risk. As a result of the determinable market rate for our revolving credit debt it is classified within Level 2 of the fair value hierarchy. The discounted cash flow of the revolving line of credit is estimated to be $16.2 million and $6.0 million, respectively, as of March 31, 2012 and July 2, 2011, which carrying value approximates the fair value.

9. Derivative Financial Instruments

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

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The Company transacts business in Mexico and is subject to the risk of foreign currency exchange rate fluctuations. The Company enters into foreign currency forward contracts to manage the foreign currency fluctuations for Mexican peso denominated payroll, utility, tax, and other local expenses. The foreign currency forward contracts have terms that were effective to the underlying transactions being hedged.

As of March 31, 2012, the Company had outstanding foreign currency forward contracts with a total notional amount of $41.0 million. These contract maturity dates extend through June 2014. The Company entered into foreign currency forward contracts of $5.0 million and settled $5.9 million of such contracts during the three months ended March 31, 2012. For the three months ended April 2, 2011, the Company entered into foreign currency forward contracts of $5.9 million and settled $3.7 million of such contracts.

For the nine months ended March 31, 2012, the Company entered into forward contracts of $17.2 million and settled $14.1 million of such contracts. For the nine months ended April 2, 2011, the Company entered into foreign currency forward contracts of $12.7 million and settled $11.2 million of such contracts.

Subsequent to March 31, 2012, the Company entered into $11.0 million of forward contracts that extended our hedge position through September 2014. In addition, the Company entered into $5.6 million of foreign cross currency swaps which will also be accounted for as cash flow hedges in accordance with ASC 815, *Derivatives and Hedging*.

The following table summarizes the fair value of derivative instruments in the Consolidated Balance Sheets as of March 31, 2012 and July 2, 2011 (in thousands):

Derivatives Designated as Hedging Instruments	Balance Sheet Location	March 31, 2012 Fair Value