KEY TRONIC CORP
Form 10-Q
February 09, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE PERIOD ENDED DECEMBER 26, 2009

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 ¨ 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 February 5, 2010, 10,090,140 shares of common stock, no par value (the only class of common stock), were outstanding.

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* Items are not applicable

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PART I: FINANCIAL INFORMATION

Item 1: Financial Statements

KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Unaudited)

	December 26, 2009	June 27, 2009
	(in thousands)	
Assets		
Current assets:		
Cash and cash equivalents	$ 7,217	$ 729
Trade receivables, net allowance for doubtful accounts of $111 and $111	26,197	24,867
Inventories	28,906	32,291
Other	3,320	3,168
Total current assets	65,640	61,055
Property, plant and equipment - net	11,597	11,199
Other assets:		
Restricted cash		124
Deferred income tax asset	4,576	4,611
Other	700	766
Total other assets	5,276	5,501
Total assets	$ 82,513	$ 77,755
Liabilities and shareholders equity		
Current liabilities:		
Accounts payable	$ 23,291	$ 18,703
Accrued compensation and vacation	3,645	3,198
Current portion of other long-term obligations	243	359
Other	1,797	1,351
Total current liabilities	28,976	23,611
Long-term liabilities:		
Revolving loan		2,412
Other long-term obligations	674	618
Total long-term liabilities	674	3,030
Total liabilities	29,650	26,641
Commitments and contingencies (Note 7)		
Shareholders equity:		
Common stock, no par value - shares authorized 25,000; issued and outstanding 10,090 and 10,066 shares, respectively	39,396	39,359

Retained earnings	12,808	10,843
Accumulated other comprehensive income	659	912
Total shareholders equity	52,863	51,114
Total liabilities and shareholders equity	$ 82,513	$ 77,755

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Second Quarters Ended	
	December 26, 2009	**December 27, 2008**
	(in thousands, except per share amounts)	
Net sales	$ 44,750	$ 46,990
Cost of sales	40,040	43,174
Gross profit on sales	4,710	3,816
Operating expenses:		
Research, development and engineering	704	592
Selling, general and administrative	2,273	2,056
Goodwill impairment		765
Total operating expenses	2,977	3,413
Operating income	1,733	403
Interest expense	19	180
Income before income tax provision	1,714	223
Income tax provision	44	117
Net income	$ 1,670	$ 106
Earnings per share - basic	$ 0.17	$ 0.01
Weighted average shares outstanding - basic	10,087	10,065
Earnings per share - diluted	$ 0.17	$ 0.01
Weighted average shares outstanding - diluted	10,110	10,073

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Six Months Ended	
	December 26, 2009	December 27, 2008
	(in thousands, except per share amounts)	
Net sales	$ 86,059	$ 95,227
Cost of sales	78,674	88,004
Gross profit on sales	7,385	7,223
Operating expenses:		
Research, development and engineering	1,267	1,218
Selling, general and administrative	4,009	4,193
Goodwill impairment		765
Total operating expenses	5,276	6,176
Operating income	2,109	1,047
Interest expense	64	362
Income before income tax provision	2,045	685
Income tax provision	80	171
Net income	$ 1,965	$ 514
Earnings per share - basic	$ 0.19	$ 0.05
Weighted average shares outstanding - basic	10,076	10,053
Earnings per share - diluted	$ 0.19	$ 0.05
Weighted average shares outstanding - diluted	10,094	10,081

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME

(Unaudited)

	Three Months Ended		Six Months Ended	
	December 26, 2009	December 27, 2008	December 26, 2009	December 27, 2008
	(in thousands)		(in thousands)	
Net income	$ 1,670	$ 106	$ 1,965	$ 514
Other comprehensive (loss) income:				
Change in fair market value of foreign exchange contracts	776	(113)	507	(113)
Comprehensive (loss) income	$ 2,446	$ (7)	$ 2,472	$ 401

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Six Months Ended December 26, 2009	Six Months Ended December 27, 2008
	(in thousands)	
Increase (decrease) in cash and cash equivalents:		
Cash flows from operating activities:		
Net income	$ 1,965	$ 514
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization	780	768
Goodwill impairment		765
Provision for doubtful accounts		75
Provision for obsolete inventory	1,425	200
Provision for warranty	16	21
Loss on disposal of assets	9	3
Changes in operating assets and liabilities:		
Trade receivables	(1,330)	6,441
Inventories	1,960	176
Other assets	(310)	610
Accounts payable	4,588	(7,011)
Accrued compensation and vacation	447	(1,832)
Other liabilities	523	124
Cash provided by operating activities	10,073	854
Cash flows from investing activities:		
Purchase of property and equipment	(1,170)	(260)
Cash used in investing activities	(1,170)	(260)
Cash flows from financing activities:		
Payment of financing costs	(50)	(50)
Repayment of long term debt	(114)	(135)
Decrease (increase) in restricted cash	124	(486)
Borrowings under revolving credit agreement	9,763	104,021
Repayment of revolving credit agreement	(12,175)	(105,374)
Proceeds from exercise of stock options	37	58
Cash used in financing activities	(2,415)	(1,966)
Net increase (decrease) in cash and cash equivalents	6,488	(1,372)
Cash and cash equivalents, beginning of period	729	2,879
Cash and cash equivalents, end of period	$ 7,217	$ 1,507
Supplemental cash flow information:		
Interest payments	$ 82	$ 375
Income tax payments, net of refunds	$ 64	$ 310

See accompanying notes to consolidated financial statements.

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KEY TRONIC CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. BASIS OF PRESENTATION

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

The Company evaluated subsequent events through the time of filing this Quarterly Report on Form 10-Q on February 9, 2010. There were no significant events that occurred subsequent to the balance sheet date but prior to the filing of this report that would have a material impact on our Consolidated Financial Statements.

The Company s reporting period is a 52/53 week fiscal year ending on the Saturday closest to June 30. The quarters ended December 26, 2009 and December 27, 2008 were 13 week periods. Fiscal year 2010 will end on July 3, 2010 which is a 53 week year.

2. NEW ACCOUNTING PRONOUNCEMENTS

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

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

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

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3. INVENTORIES

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

	December 26, 2009	June 27, 2009
Finished goods	$ 3,692	$ 7,898
Work-in-process	4,392	3,968
Raw materials and supplies	20,822	20,425
	$ 28,906	$ 32,291

4. LONG-TERM DEBT

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

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

The new line of credit is secured by substantially all of the assets of the Company. Based on the trailing four quarters EBITDA as of December 26, 2009, the Company could borrow up to $18.2 million under the Wells Fargo line of credit. There was no outstanding balance under the credit facility as of December 26, 2009. As of December 27, 2008, the range of interest being paid to CIT on outstanding balances was 4.13% to 5.00%.

5. INCOME TAXES

The Company had domestic income tax loss carryforwards of approximately $33.2 million at June 27, 2009. In accordance with FASB ASC Topic 740, *Income Taxes,* a valuation allowance is required if it is more likely than not that some or all of the deferred tax assets will not be realized in the future. Management assessed the Company s recent operating levels and the sources of future taxable income to estimate a valuation allowance. Management has determined that the valuation allowance of $8.1 million is appropriate as of December 26, 2009. The Company s judgments regarding future use of deferred tax assets may change due to changes in market conditions, changes in tax laws or other factors. If assumptions and estimates change in the future the valuation allowance will be adjusted accordingly and any increase or decrease will result in an additional income tax expense or benefit.

In addition to its domestic operations, the Company has subsidiaries in Mexico and China. The Company is currently applying certain tax credits to offset the income tax liabilities of its Mexican subsidiaries. As of January 1, 2008, the Company became subject to a Mexican business flat tax called Impuesto Empresarial a Tasa Unica (IETU). The effect of IETU and an associated presidential decree in fiscal year 2009 has been included in the effective tax rate for the six months ended December 26, 2009 and was approximately $55,000. Accordingly, the income tax provisions for the second quarter of fiscal years 2010 and 2009 are primarily attributable to the taxable earnings of the Company s foreign subsidiaries.

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

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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 options that were not included. These antidilutive securities occur when options outstanding have an option price greater than the average market price for the period:

	Second Quarters Ended (in thousands, except per share information)	
	December 26, 2009	December 27, 2008
Net income	$ 1,670	$ 106
Weighted average shares outstanding - basic	10,087	10,065
Effect of dilutive common stock options	23	8
Weighted average shares outstanding - diluted	10,110	10,073
Earnings per share - basic	$ 0.17	$ 0.01
Earnings per share - diluted	$ 0.17	$ 0.01
Antidilutive options not included in diluted earnings per share	445,000	932,000

	Six Months Ended (in thousands, except per share information)	
	December 26, 2009	December 27, 2008
Net income	$ 1,965	$ 514
Weighted average shares outstanding - basic	10,076	10,053
Effect of dilutive common stock options	18	28
Weighted average shares outstanding - diluted	10,094	10,081
Earnings per share - basic	$ 0.19	$ 0.05
Earnings per share - diluted	$ 0.19	$ 0.05
Antidilutive options not included in diluted earnings per share	445,000	886,000

7. COMMITMENTS AND CONTINGENCIES

Purchase Commitments

The Company had no material firm commitments to contractors and suppliers for capital expenditures at December 26, 2009.

Leases

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

Warranties

The Company provides warranties on certain product sales. Allowances for estimated warranty costs are recorded during the period of sale. The determination of such allowances requires the Company to make estimates of product return rates and expected costs to repair or to replace the products under warranty. The Company currently establishes warranty reserves based on historical warranty costs for each product line combined with liability estimates based on the prior twelve months sales activities. If actual return rates and/or repair and replacement costs differ significantly from management s estimates, adjustments to recognize additional cost of sales may be required in future periods. The Company s warranty reserve was $20,000 and $25,000 as of December 26, 2009 and June 27, 2009, respectively.

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8. FAIR VALUE MEASUREMENTS

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

The following tables summarize the Company s financial assets and liabilities measured at fair value on a recurring basis as of December 26, 2009 and June 27, 2009 (in thousands):

	December 26, 2009				
	Level 1	Level 2	Level 3	Netting Adjustment[1]	Total Fair Value
Financial Assets:					
Foreign currency forward contracts	$	$ 769	$	$ (110)	$ 659
Financial Liabilities:					
Foreign currency forward contracts	$	$ (110)	$	$ 110	$

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

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

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

The Company currently has forward contracts to lock in 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 reported as a component of shareholders equity in accumulated other comprehensive income, as they qualify for hedge accounting.

The carrying values of the remaining financial instruments reflected on the balance sheet as of December 26, 2009 and June 27, 2009, reasonably approximate their fair value. Based on the borrowing rates currently available to the Company for loans with similar terms and average maturities, the fair value of long-term debt as of June 27, 2009 approximates the carrying value.

9. DERIVATIVE FINANCIAL INSTRUMENTS

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

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

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As of December 26, 2009, the Company had outstanding foreign currency forward contracts of $23.5 million. These contract maturity dates do not exceed 18 months. As of December 26, 2009, the net amount of existing gains expected to be reclassified into earnings within the next 12 months was $713,000.

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

The following table summarizes the fair value of derivative instruments in the Consolidated Balance Sheets as of December 26, 2009 and June 27, 2009 (in thousands):

Derivatives Designated as Hedging Instruments	Balance Sheet Location	December 26, 2009 Fair Value[1]	June 27, 2009 Fair Value[1]
Foreign currency forward contracts	Other current assets	$ 659	$ 912

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

As of December 26, 2009, the Company does not have any foreign exchange contracts with credit-risk-related contingent features. The Company entered into foreign currency forward contracts of $10.6 million and settled $4.5 million of such contracts during the three months ended December 26, 2009.

The following table summarizes the effect of derivative instruments on the Consolidated Financial Statements for the three months ended December 26, 2009 (in thousands):

Derivatives Designated as Hedging Instruments	AOCI Balance as of September 26, 2009	Effective Portion Recorded In AOCI	Effective (Gain) Reclassified From AOCI Into Cost of Sales	AOCI Balance as of December 26, 2009
Settled foreign currency forward contracts for the three months ended December 26, 2009	$ 306	$ 209	$ (515)	$
Unsettled foreign currency forward contracts	(117)	776		659
Total	$ 189	$ 985	$ (515)	$ 659

The Company entered into foreign currency forward contracts of $14.6 million and settled $9.0 million of such contracts during the six months ended December 26, 2009.

The following table summarizes the effect of derivative instruments on the Consolidated Financial Statements for the six months ended December 26, 2009 (in thousands):

Derivatives Designated as Hedging Instruments	AOCI Balance as of June 27, 2009	Effective Portion Recorded In AOCI	Effective (Gain) Reclassified From AOCI Into Cost of Sales	AOCI Balance as of December 26, 2009
Settled foreign currency forward contracts for the six months ended December 26, 2009	$ 760	$ 142	$ (902)	$

Unsettled foreign currency forward contracts		152		507			659
Total	$	912	$	649	$	(902)	$ 659

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10. GOODWILL

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

As of December 27, 2008, the Company completed its annual impairment test. The Company performed the first step of its goodwill impairment test and determined that the book value of the Company exceeded its fair value based on the quoted market price of the Company s stock as of December 26, 2008. The result of the first step indicated that goodwill was impaired and therefore, the Company performed the second step of the goodwill analysis in accordance with FASB ASC Topic 350. The second step analyzes any excess or implied fair value of goodwill upon allocating the fair value of the Company to all its assets and liabilities other than goodwill and then comparing the residual amount, if any, to the book value of the goodwill. There was no residual amount of goodwill to allocate upon completing this step. As the deteriorating global economy adversely affected the Company s common stock price, the Company concluded that 100% of the goodwill was impaired due to the significant and sustained decline in the Company s market capitalization to below the book value. The Company recorded an impairment charge of $765,000 for the quarter ended December 27, 2008. As of December 26, 2009, there was no goodwill recorded in the Company s Consolidated Balance Sheet.

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

FORWARD-LOOKING STATEMENTS

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

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

OVERVIEW

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

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

The EMS industry experienced growth over the past several years as more original equipment manufacturers (OEMs) chose to outsource manufacturing. This expansion of the EMS industry allowed us to continue to expand our customer base and the industries that we serve. The recent challenging global economic environment has, however, had a negative impact on our results of operations as the demand from our customers has declined. We successfully confronted the challenging global economic environment in fiscal year 2009 by reducing our costs while ramping up new customer programs, which allowed us to maintain profitability and strengthen our balance sheet. The ramp up for our new programs was slowed by the recession, but these new programs continue to represent a growing portion of our revenue and a promising foundation for our future. In keeping with our long-term strategic objectives, we have been successfully building a more diversified customer portfolio and a less concentrated revenue base, spanning a wider range of industries. We currently offer our customers the following services: integrated electronic and mechanical engineering, precision plastic molding, assembly, component selection, sourcing and procurement, worldwide logistics, and new product testing and production all at competitive pricing due to our global footprint.

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

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

Sales for the second quarter of fiscal year 2010 decreased 4.8% to $44.8 million compared to $47.0 million for the same period of fiscal year 2009. This decrease in sales reflects the expected lower demand from established customers due to the unfavorable global economic situation. The decline in demand from our established customers programs was partially offset by revenue from new customers and revenue from new programs with existing customers. In the second quarter of fiscal year 2009 new customers contributed 21.8% of revenue. These same customers, plus additional new customers, in the second quarter of fiscal year 2010 contributed 51.8% of revenue. Sales for the first six months of fiscal 2010 were $86.1 million or a decrease of 9.6% from $95.2 million during the same period of the prior year.

In the second quarter of fiscal 2010, we continued to successfully meet the challenges of the global recession by reducing our costs while ramping up our new customer programs and further diversifying our customer portfolio across a wide range of industries. Despite the macro-economic uncertainty, we remain strongly positioned to win new business and currently expect to see growth in the second half of our fiscal year, driven by increased production levels of our new programs for both new and longstanding customers. Sales in the third quarter of fiscal year 2010 are expected to be in the range of $44 million to $47 million. Future results will depend on actual levels of customers orders and the timing of the start up of production of new product programs. We believe that we are well positioned in the EMS industry to continue expansion of our customer base and continue long-term growth.

Net income for the second quarter of fiscal year 2010 was $1.7 million compared to $106,000 for the second quarter of fiscal year 2009. The increase in the net income for the second quarter of fiscal year 2010 as compared to the second quarter of fiscal year 2009 was due to costs incurred in 2009 that did not recur in 2010. In the second quarter of fiscal year 2009, we recorded a goodwill impairment charge of $765,000. In that quarter, we also incurred severance costs of $400,000 due to a workforce reduction in our Juarez plant and we also incurred foreign exchange losses on hedge contracts of approximately $300,000 due to the decline in the value of the Mexican peso.

Gross profit as a percentage of sales for the second quarter of fiscal year 2010 was 10.5% compared to 8.1% for the second quarter of fiscal year 2009. Gross profit was 8.6% for the first six months of fiscal 2010 compared to 7.6% for the first six months of fiscal 2009. The increase in gross profit as a percentage of net sales was due to lower payroll costs in 2010 resulting from workforce reductions as well as severance costs and foreign exchange losses (described above) incurred in 2009 that did not recur in 2010.

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The level of gross margin is impacted by facility utilization, product mix, timing of the start up of new programs, and pricing within the electronics industry and material costs, which can fluctuate significantly from quarter to quarter.

We maintain a strong balance sheet with a current ratio of 2.3 and a long-term debt to equity of 0. Total cash provided by operations was $10.1 million for the six months ended December 26, 2009. We maintain sufficient liquidity for our expected future operations and had approximately $18.2 million available from our Wells Fargo Bank, N.A. line of credit as of December 26, 2009. We believe the internally generated funds, our borrowing capacity, and equipment leasing should provide adequate capital for planned growth over the long term.

On August 19, 2009, we entered into a credit agreement with Wells Fargo Bank, N.A. providing for a revolving line of credit facility of up to $20 million and paid off our CIT revolving loan. The agreement with Wells Fargo Bank, N.A. specifies that we, and our subsidiaries, use the proceeds of the revolving line of credit primarily for working capital and general corporate purposes. We may elect to borrow under this revolving line of credit at an interest rate of either a Base Rate or a Fixed Rate . The base rate is the higher of the prime rate, daily one month 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 trailing four quarters EBITDA.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Revenue Recognition

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

- Persuasive evidence of an arrangement exists.
- Delivery has occurred or services have been rendered.
- The seller s price to the buyer is fixed or determinable.
- Collectibility is reasonably assured.

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

- Customer purchase orders confirming the price, shipping terms, and payment terms are required prior to shipment. The terms of our sales are generally FOB shipping point, meaning that the customer takes ownership of the goods and assumes the risk of loss when the goods leave our premises.
- The seller s price to the buyer is fixed or determinable as noted, we require a customer purchase order, which confirms the price, shipping and payment terms.
- Collectibility is reasonably assured the credit terms for customers are pre-established based on a review of the customers perceived ability to pay so that collection of the account can be reasonably assured.

Inactive, Obsolete, and Surplus Inventory Reserve

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

Allowance for Doubtful Accounts

We value our accounts receivable net of an allowance for doubtful accounts of $111,000 at December 26, 2009 and June 27, 2009. This allowance is based on estimates of the portion of accounts receivable that may not be collected in the future. The estimates used are based primarily on specific identification of potentially uncollectible accounts. Such accounts are identified using publicly available information in conjunction with evaluations of current payment activity. However, if any of our customers were to develop unexpected and immediate financial problems that would prevent payment of open invoices, we could incur additional and possibly material expenses that would negatively impact earnings.

Accrued Warranty

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

Income Taxes

We had domestic tax loss carryforwards of approximately $33.2 million and other future deductible temporary differences and tax credit carryforwards at June 27, 2009. In accordance with FASB ASC Topic 740, *Income Taxes*, we assess the sources of future taxable income, based on management s estimates, which may be available to recognize the deductible differences that comprise deferred tax assets. A valuation allowance against deferred tax assets is required if it is more likely than not that some or all of the deferred tax assets will not be realized. We have determined that a valuation allowance of $8.1 million on the total deferred tax asset is appropriate as of December 26, 2009. Our judgments regarding future use of deferred tax assets may change due to changes in market conditions, changes in tax laws or other factors. If our assumptions and estimates change in the future, the valuation allowance will be adjusted accordingly and any increase or decrease will result in an additional income tax expense or benefit.

Derivatives

We adopted FASB ASC Topic 815, *Derivatives and Hedging,* as of March 28, 2009. All material derivative instruments are recorded on the balance sheet at their respective fair values. Generally, if a derivative instrument is specifically designated as a cash flow hedge, the change in the fair value of the derivative is recorded in other comprehensive income to the extent the derivative is effective, and recognized in the statement of operations when the hedged item affects earnings. As of December 26, 2009, we had forward contracts to lock in known future cash outflows for payroll, utility, tax, and accounts payable expenses denominated in the Mexican peso. As of December 26, 2009, the fair value of these contracts was an asset of $659,000 which was included in other current assets and recorded as unrealized income in accumulated other comprehensive income.

Goodwill

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

As of December 27, 2008, the Company completed its annual impairment test. The Company performed the first step of its goodwill impairment test and determined that the book value of the Company exceeded its fair value based on the quoted market price of the Company s stock as of December 26, 2008. The result of the first step indicated that goodwill was impaired and therefore, the Company performed the second step of the goodwill analysis in accordance with FASB ASC Topic 350. The second step analyzes any excess or implied fair value of goodwill upon allocating the fair value of the Company to all its assets and liabilities other than goodwill and then comparing the residual amount, if any, to the book value of the goodwill. There was no residual amount of goodwill to allocate upon completing this step. As the deteriorating global economy adversely affected the Company s common stock price, the Company concluded that 100% of the goodwill was impaired due to the significant and sustained decline in the Company s market capitalization to below the book value. The Company recorded an impairment charge of $765,000 for the quarter ended December 27, 2008. As of December 26, 2009, there was no goodwill recorded in the Company s Consolidated Balance Sheet.

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RESULTS OF OPERATIONS

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

	Second Quarter Ended		Six Months Ended	
	December 26, 2009	December 27, 2008	December 26, 2009	December 27, 2008
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales	89.5	91.9	91.4	92.4
Gross profit	10.5	8.1	8.6	7.6
Operating expenses				
Research, development and engineering	1.6	1.3	1.5	1.3
Selling, general and administrative	5.1	4.4	4.7	4.4
Goodwill impairment	0.0	1.6	0.0	0.8
Total operating expenses	6.7	7.3	6.2	6.5
Operating income	3.8	0.8	2.4	1.1
Interest expense	0.0	0.4	0.1	0.4
Income before income taxes	3.8	0.4	2.3	0.7
Income tax provision	0.1	0.2	0.1	0.2
Net income	3.7%	0.2%	2.2%	0.5%

Sales

Sales for the second quarter of fiscal year 2010 decreased 4.8% to $44.8 million compared to $47.0 million for the same period of fiscal year 2009. This decrease in sales reflects the expected lower demand from established customers due to the unfavorable global economic situation. The decline in demand from our established customers programs was partially offset by revenue from new customers and revenue from new programs with existing customers. In the second quarter of fiscal year 2009 new customers contributed approximately 21.8% of revenue. These new customers, plus additional new customers, in the second quarter of 2010 contributed 51.8% of revenue. Sales for the first six months of fiscal 2010 were $86.1 million or a decrease of 9.6% from $95.2 million during the same period of the prior year.

In the second quarter of fiscal 2010, we continued to successfully meet the challenges of the global recession by reducing our costs while ramping up our new customer programs and further diversifying our customer portfolio across a wide range of industries. Despite the macro-economic uncertainty, we remain strongly positioned to win new business and currently expect to see growth in the second half of our fiscal year, driven by increased production levels of our new programs for both new and longstanding customers. Sales in the third quarter of fiscal year 2010 are expected to be in the range of $44 million to $47 million. Future results will depend on actual levels of customers orders and the timing of the start up of production of new product programs. We believe that we are well positioned in the EMS industry to continue expansion of our customer base and continue long-term growth.

Sales to our largest customers may vary significantly from quarter to quarter depending on the size and timing of customer program commencement, forecasts, delays, and design modifications. We remain dependent on continued sales to our significant customers and most contracts with customers are not firm long-term purchase commitments. Only a short window of approximately three to six months of total demand information is provided to us by our customers. We seek to maintain flexibility in production capacity by employing skilled temporary and short-term labor and by utilizing short-term leases on equipment and manufacturing facilities. In addition, our capacity and core competencies for printed circuit board assemblies (PCBAs), precision molding, tool making, assembly, and engineering can be applied to a wide variety of products.

Gross Profit

Gross profit as a percentage of sales for the second quarter of fiscal year 2010 was 10.5% compared to 8.1% for the second quarter of fiscal year 2009. Gross profit was 8.6% for the first six months of fiscal 2010 compared to 7.6% for the first six months of fiscal 2009. The increase in gross profit as a percentage of sales for the second quarter of fiscal year 2010 and the first six months of fiscal 2010 as compared to the same periods of fiscal 2009, was due to reduced labor related costs, improved production efficiencies and lower operating expenses as the result of favorable exchange rates. The level of gross margin is impacted by facility utilization, product mix, timing of the start up of new programs, pricing within the electronics industry and material costs, which can fluctuate significantly from quarter to quarter.

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Included in gross profit are charges related to changes in the allowance for obsolete inventory. Specifically, we had provisions for obsolete inventory of $1.4 million and $200,000 for the first six months of fiscal year 2010 and 2009, respectively. We adjust the allowance for estimated obsolescence as necessary in an amount equal to the difference between the cost of inventory and estimated market value based on assumptions of future demand and market conditions. The reserves are established for inventory that we have determined customers are not contractually responsible for and for inventory that we believe customers will be unable to purchase. Also included in 2009 results were severance costs of $400,000 due to workforce reduction and foreign exchange losses in hedge contracts of $300,000.

Operating Expenses

Total operating expenses were $3.0 million in the second quarter of fiscal year 2010 and $3.4 million in the second quarter of fiscal year 2009. The difference was mainly attributable to a goodwill impairment charge of $765,000 in 2009 partially offset by higher payroll costs primarily for incentive compensation in 2010. Operating expenses as a percentage of sales decreased to 6.7% in the second quarter of fiscal year 2010 from 7.3% in the second quarter of fiscal year 2009. Operating expenses for the first six months of fiscal year 2010 were $5.3 million compared to $6.2 million in the first six months of fiscal year 2009. Operating expenses as a percentage of sales decreased to 6.2% in the first six months of fiscal year 2010 from 6.5% in the first six months of fiscal year 2009. The decrease in total operating expenses during the first six months of fiscal year 2010 when compared to the same period of fiscal year 2009, was mainly due to the goodwill impairment charge recorded in 2009.

Total SG&A expenses were $2.3 million and $2.1 million during the second quarters of fiscal years 2010 and 2009, respectively. The difference was mainly attributable to higher payroll costs due to higher incentive compensation which was partially offset by lower headcount. SG&A expenses for the first six months of fiscal year 2010 were $4.0 million compared to $4.2 million in the first six months of fiscal year 2009. Lower SG&A expense for the first six months of fiscal 2010 compared to the same periods of fiscal 2009 were attributable to lower charges for doubtful receivables and lower payroll expense due to a workforce reduction which was partially offset by higher incentive compensation. For the first six months of fiscal year 2010 there was no charge to provide for doubtful collection of receivables. A charge of $75,000 for doubtful collection was recorded in the first six months of fiscal year 2009.

Total research, development, and engineering (RD&E) expenses were $704,000 and $592,000 during the second quarters of fiscal years 2010 and 2009, respectively. RD&E expenses were $1.3 million and $1.2 million in the first six months of fiscal 2010 and 2009, respectively. Higher RD&E expenses in the second quarter and the first six months of fiscal year 2010 compared to the same periods of fiscal year 2009 were the result of higher incentive compensation.

Interest

Interest expense decreased to $19,000 in the second quarter of fiscal year 2010 from $180,000 in the second quarter of fiscal year 2009. For the first six months of fiscal years 2010 and 2009, interest expense amounted to $64,000 and $362,000, respectively. The decreases in interest expense in the second quarter and first six months of fiscal year 2010 compared to the same periods of fiscal year 2009 are due to a decrease in the average outstanding revolving credit facility balance and a decrease in variable interest rates.

Income Taxes

We had domestic income tax loss carryforwards of approximately $33.2 million at June 27, 2009. In accordance with FASB ASC Topic 740, *Income Taxes,* a valuation allowance is required if it is more likely than not that some or all of the deferred tax assets will not be realized in the future. Management assessed our recent operating levels and the sources of future taxable income to estimate a valuation allowance. We determined that the valuation allowance of $8.1 million is appropriate as of December 26, 2009. Our judgments regarding future use of deferred tax assets may change due to changes in market conditions, changes in tax laws or other factors. If assumptions and estimates change in the future the valuation allowance will be adjusted accordingly and any increase or decrease will result in an additional income tax expense or benefit.

In addition to our domestic operations, we have subsidiaries in Mexico and China. We are currently applying certain tax credits to offset the income tax liabilities of our Mexican subsidiaries. As of January 1, 2008, we became subject to a Mexican business flat tax called Impuesto Empresarial a Tasa Unica (IETU). The effect of IETU and an associated presidential decree on fiscal year 2010 results has been included in the effective tax rate for the six months ended December 26, 2009 and was approximately $55,000. Accordingly, the income tax provisions for the second quarter of fiscal years 2010 and 2009 are primarily attributable to the taxable earnings of our foreign subsidiaries.

Backlog

On December 26, 2009, we had an order backlog of approximately $33.6 million. This compares with a backlog of approximately $30.3 million on December 27, 2008. The change in backlog at December 26, 2009, when compared to December 27, 2008, was due to the additional new customers we added this year. Order backlog consists of purchase orders received for products expected to be shipped within the next 12 months, although shipment dates are subject to change due to design modifications or changes in other customer requirements. Order backlog should not be considered an accurate measure of future sales.

CAPITAL RESOURCES AND LIQUIDITY

Operating Cash Flow

Net cash provided by operating activities for the six months ended December 26, 2009 was $10.1 million, compared to $854,000 provided during the same period of the prior fiscal year. This consisted primarily of net income of $2.0, a $3.4 million decrease in inventory (which includes a $1.4 million provision for obsolete inventory) and a $4.6 million increase in accounts payable. The decrease in inventory was attributable to a reduction of finished goods (principally for one specific customer) and the increase in accounts payable was primarily driven by extending payment terms during the first six months of fiscal year 2010. Accounts payable fluctuates with changes in inventory levels and negotiated supplier terms. We purchase inventory based on customer forecasts and orders, and when those forecasts and orders change the amount of inventory may also fluctuate.

Investing Cash Flow

During the first six months of fiscal year 2010, we spent $1.2 million for capital additions compared to $260,000 in the same period of the previous fiscal year. Our capital expenditures primarily consist of purchases of manufacturing equipment to support our production facilities. We also use leases to acquire equipment. Operating leases are often utilized when potential technical obsolescence and funding requirement advantages outweigh the benefits of equipment ownership. Capital expenditures and periodic lease payments are expected to be financed with internally generated funds.

Financing Cash Flow

Our primary financing activity during the first six months of fiscal years 2010 and 2009 was borrowing and repayment under our revolving line of credit facility. Our credit agreement with Wells Fargo Bank N.A. provides a revolving line of credit facility of up to $20 million, subject to availability. The agreement specifies that the proceeds of the revolving line of credit be used primarily for working capital and general corporate purposes of the Company and its subsidiaries. Borrowings under this revolving line of credit bear interest at either a Base Rate or a Fixed Rate , as elected by the Company. The base rate is the higher of the JP Morgan Chase prime rate, daily one month 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 trailing four quarters EBITDA.

As of December 26, 2009, we were in compliance with our loan covenants and approximately $18.2 million was available under the revolving line of credit facility.

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

Restricted cash included amounts in our bank account that must be used to pay down our revolving line of credit.

RISKS AND UNCERTAINTIES THAT MAY AFFECT FUTURE RESULTS

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

Potential Fluctuations in Quarterly Results

Our quarterly operating results have varied in the past and may vary in the future due to a variety of factors, including adverse changes in the U.S. and global economic environment, volatility in overall demand for our customers products, success of customers programs, timing of new programs, new product introductions or technological advances by us, our customers and our competitors, and changes in pricing policies by us, our customers, our suppliers, and our competitors. Our customer base is diverse in the markets they serve, however, decreases in demand, particularly from customers that supply the banking and gambling industries, could affect future quarterly results. Additionally, our customers could be impacted by the illiquidity of the credit markets which could directly impact our operating results.

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

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

Economic Conditions

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

Credit Markets

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

Concentration of Credit Risk

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

Competition

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

Concentration of Major Customers

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

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

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Dependence on Suppliers

We are dependent on many suppliers, including sole source suppliers, to provide key components and raw materials used in manufacturing customers products. Delays in deliveries from suppliers or the inability to obtain sufficient quantities of components and raw materials could cause delays or reductions in shipment of products to our customers which could adversely affect our operating results and damage customer relationships.

Foreign Manufacturing Operations

Most of the products manufactured by us are produced at our facilities located in Mexico and China. Accordingly, our operations are subject to a variety of risks and factors unique to international operations including foreign economic and political risk; civil unrest; import and export duties; currency fluctuations; value added taxes; import and export regulation changes; and the burden; and cost of compliance with foreign laws.

Dependence on Key Personnel

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

Technological Change and New Product Risk

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

Interest Rate Risk

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

Compliance with Current and Future Environmental Regulation

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

Foreign Currency Fluctuations

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

Dilution and Stock Price Volatility

As of December 26, 2009, there were outstanding options for the purchase of 504,000 shares of our common stock, all of which were vested and exercisable. Holders of the common stock will suffer immediate dilution to the extent outstanding options to

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purchase the common stock are exercised. Our stock price may be subject to wide fluctuations and possible rapid increases or declines over a short time period. These fluctuations may be due to factors specific to us such as variations in quarterly operating results or changes in earnings estimates, or to factors relating to the EMS industry or to the securities markets in general, which, in recent years, have experienced significant price fluctuations. These fluctuations often have been unrelated to the operating performance of the specific companies whose stocks are traded.

Disclosure and Internal Controls

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Risk

We are subject to the risk of fluctuating interest rates in the normal course of business. Our major market risk relates to our secured debt. Our revolving credit facility is secured by substantially all of our assets. The interest rates applicable to our revolving credit facility fluctuate with the JP Morgan Chase Bank prime rate and LIBOR rates. We did not have an amount outstanding under our revolving credit facility as of December 26, 2009. See Management s Discussion and Analysis of Financial Condition and Results of Operations Capital Resources and Liquidity and Note 4 Long-Term Debt to the Consolidated Financial Statements for additional information regarding our revolving credit facility.

Foreign Currency Exchange Risk

A significant portion of our operations are in foreign locations. As a result, transactions occur in currencies other than the U.S. dollar. Exchange rate fluctuations among other currencies used by us would directly or indirectly affect our financial results. We currently use Mexican peso forward contracts to hedge foreign currency fluctuations for a portion of our Mexican peso denominated expenses. There were $23.5 million outstanding foreign currency forward contracts as of December 26, 2009. The fair value of these contracts was $659,000 and was recorded in other current assets in the Consolidated Balance Sheet as of December 26, 2009. See Note 9 Derivative Financial Instruments to the Consolidated Financial Statements for additional information regarding our derivative instruments.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

It is the responsibility of our management to establish, maintain, and monitor disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934 are recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms. Additionally, these disclosure controls include controls and procedures that are designed to accumulate and communicate the information required to be disclosed to our company s Chief Executive Officer and Chief Financial Officer, allowing for timely decisions regarding required disclosures. As of the end of the period covered by this report, our management carried out an evaluation, under the supervision and with the participation of the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15(f). Based on our assessment, we believe that as of December 26, 2009, the Company s disclosure controls and procedures are effective based on that criteria.

Changes in Internal Control over Financial Reporting

There have been no significant changes in our internal controls over financial reporting during our second quarter ended December 26, 2009 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting (as defined in Exchange Act Rules 13a 15(f) and 15d 15(f)).

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PART II. OTHER INFORMATION:

Item 1A. Risk Factors
Information regarding risk factors appear in Item 2, Management s Discussion and Analysis of Financial Condition and Results of Operations and Item 3, Quantitative and Qualitative Disclosures about Market Risk of this Form 10-Q.

There are no material changes to the risk factors set forth in Part I Item 1A in the Company s Annual Report on Form 10-K for the year ended July 3, 2010.

Item 4. Submission of Matters to a Vote of Security Holders
The Annual Meeting of Shareholders was held on October 22, 2009 at which shareholders voted on proposals as follows:

		Votes For	**Votes Against or Withheld**	**Votes Abstained**
Proposal 1:	Election of Directors:			
	James R. Bean	9,082,218	323,777	
	Craig D. Gates	9,317,113	88,882	
	Ronald F. Klawitter	9,174,548	231,447	
	Dale F. Pilz	9,030,035	375,960	
	Yacov A. Shamash	9,291,899	114,096	
	Patrick Sweeney	9,082,081	323,914	
Proposal 2:	Ratification of Appointment of BDO Seidman, LLP as independent auditors for fiscal year 2010	9,379,415	19,374	12,700

Item 6. Exhibits
(31.1) Certification of Chief Executive Officer (Exchange Act Rules 13(a)-14 and 15(d)-14)

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

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

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

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SIGNATURES

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

KEY TRONIC CORPORATION

/s/ Craig D. Gates Craig D. Gates (President and Chief Executive Officer)	Date: February 9, 2010
/s/ Ronald F. Klawitter Ronald F. Klawitter (Principal Financial Officer and Principal Accounting Officer)	Date: February 9, 2010