KEY TRONIC CORP
Form 10-K
September 09, 2016

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

FORM 10-K

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE FISCAL YEAR ENDED JULY 2, 2016
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 (State or other jurisdiction of Incorporation or organization)	91-0849125 (I.R.S. Employer Identification No.)
N. 4424 Sullivan Road, Spokane Valley, Washington (Address of principal executive offices)	99216 (Zip Code)

(509) 928-8000
(Registrant's telephone number, including area code)
N/A
(Former name, former address and former fiscal year, if changed since last report)

Securities Registered Pursuant to Section 12(b) of the Act: None

Title of each class	Name of each exchange on which registered
Common stock, no par value	The NASDAQ Stock Market LLC

Securities Registered Pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes ¨ No x

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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

(Check one):

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

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

State the aggregate market value of the voting and non-voting common equity held by non affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter.

As of December 26, 2015, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was $79.2 million based on the closing price as reported on the NASDAQ.

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 10,756,018 shares of common stock were outstanding as of September 7, 2016.

Documents Incorporated by Reference:

Certain information is incorporated into Part III of this report by reference to the Proxy Statement for the registrant's 2017 annual meeting of stockholders to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this Form 10-K.

KEY TRONIC CORPORATION
2016 FORM 10-K
TABLE OF CONTENTS

PART IV

FORWARD-LOOKING STATEMENTS

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

This Annual Report on Form 10-K 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 Quarterly Reports on Form 10-Q and Current Reports on Form 8-K.

PART I

Item 1. BUSINESS

Background

Key Tronic Corporation (dba: KeyTronicEMS Co.) was organized in 1969, as a Washington corporation that locally manufactured computer keyboards. The ability to design, build and deliver a quality product led us to become 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, we shifted our focus from keyboard manufacturing to contract manufacturing for a wide range of products. Our unique strategic attributes are based on our core strengths of innovative design and engineering expertise in electronics, mechanical engineering, sheet metal fabrication and stamping, and precision plastics combined with high-quality, low cost production, and assembly on an international basis while providing exceptional customer service. These strengths have made our company a strong competitor in the electronic manufacturing services (EMS) market.

Acquisitions

On September 3, 2014, we completed the acquisition of all of the outstanding shares of CDR Manufacturing, Inc. (dba Ayrshire Electronics), which added five locations (four in North America and one in Mexico). This acquisition expanded our printed circuit board assembly capacity, total revenue, and adds to and diversifies our customer base with the addition of many new multi-national companies. Subsequent to the acquisition, the Reynosa, Mexico operations were transferred to the Company’s existing Juarez, Mexico facilities. During the fourth quarter of fiscal year 2016, we announced a plan to close the Harrodsburg, Kentucky facility which is expected to occur by the end of the first quarter of 2017. Most of our customer programs from the Harrodsburg, Kentucky facility are being transferred to other Key Tronic facilities.

On July 1, 2013, the Company acquired substantially all of the assets of Sabre Assembly & Manufacturing Co. of Texas (“Sabre”), a sheet metal fabrication company with facilities located in Juarez, Mexico. We have made substantial investments in our sheet metal fabrication capabilities and capacity and will continue to do so as customer demands increase and evolve. The significant investment in sheet metal capabilities enables the Company to offer metal fabrication directly to its customers, in combination with plastic molding, PCB assembly, complete product assembly, design engineering and testing engineering services.

Our Industry and Strategy

The expansion of the EMS industry and our acquisitions have allowed us to continue to expand our customer base and the industries that we serve. The increase in new programs represents 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, spanning a wider range of industries. We currently offer our customers the following services: integrated electronic and mechanical engineering, precision plastic molding, sheet metal fabrication, printed circuit board (PCB) and complete product 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 unique blend of multinational facilities, vertical integration, centralized management, and 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 international 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 pressure for new 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.

The EMS industry is intensely competitive. Although our customer base is growing, we still 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 with new and existing customers, increasing our worldwide manufacturing capacity, and continuing to improve our manufacturing and procurement processes. Ongoing challenges that we face include but are not limited to the following: Continuing to win programs from new and existing customers, balancing capital employed, production capacity and key personnel in support of new customer programs, improving operating efficiencies, controlling costs while developing competitive pricing strategies, and successfully transitioning new program wins to full production.

Customers and Marketing

We provide a mix of manufacturing services for outsourced Original Equipment Manufacturing (OEM) products. We provide the following EMS services: Product design, surface mount technologies (SMT) and pin through hole capability for printed circuit board assembly, tool making, precision plastic molding, sheet metal fabrication, liquid injection molding, complex assembly, automated tape winding, prototype design and full product assembly.

Sales of the majority of our products have not historically been seasonal in nature, but may be seasonal in the future if there are changes in the types of products manufactured. Sales can, however, fluctuate significantly between quarters from changes in customers and customer demand due to the concentration of sales generated by our largest customers. For the fiscal years 2016, 2015 and 2014, the five largest customers in each year accounted for 41%, 42% and 62% of combined total net sales, respectively. The decrease in concentration compared to 2014 was primarily the result of the acquisition of Ayrshire as well as the impact of the reduction in production levels for a certain longstanding customer. We continue to diversify our customer base by adding additional programs and customers. We expect net sales to our five largest customers as a percentage of total net sales to approximate current levels going forward.

The following table represents all customers that represented 10% or more of total net sales during the last three fiscal years:

	Percentage of Net Sales by Fiscal Year		
	2016	2015	2014
Customer A	18%	17%	20%
Customer B	*	*	15%
Customer C	*	*	15%

* Current customer amount represents less than 10%.

There can be no assurance that the Company's principal customers will continue to purchase products from the Company at current levels. Moreover, the Company typically does not enter into long-term volume purchase contracts with its customers, and the Company's customers have certain rights to extend or delay the shipment of their orders. The loss of one or more of the Company's major customers, or the reduction, delay or cancellation of orders from such customers, could materially and adversely affect the Company's business, operating results and financial condition.

We market our products and services primarily through our direct sales department which is comprised of strategically located field sales people and distributors. We also maintain relationships with several independent sales organizations to assist in marketing our EMS product lines.

Manufacturing

We have continually made investments in developing and expanding a capital equipment base to achieve vertical integration and efficiencies in our manufacturing processes. We have invested significant capital into SMT for volume manufacturing of complex printed circuit board assemblies and in our metal shop providing precision metal stamping, fabricating, and finishing. We also design and develop tooling for injection molding and sheet metal fabrication and manufacture the majority of plastic and sheet metal parts used in the products we manufacture. Additionally, we have equipment to maintain a controlled clean environment for manufacturing processes that require a high level of precise control.

We use a variety of manual and automated assembly processes in our facilities, depending upon product complexity and degree of customization. Some examples of automated processes include component insertion, SMT, selective soldering, flexible robotic assembly, automated storage tape winding, computerized vision system quality inspection, laser turrets, automated switch and key top installation, and automated functional testing.

Our engineering expertise and automated manufacturing processes enable us to work closely with our customers during the design and prototype stages of production and to jointly increase productivity and reduce response time to the marketplace. We use computer-aided design techniques and software to assist in preparation of the tool design layout and component placement, to reduce tooling and production costs, improve component and product quality, and enhance turnaround time during product development.

We purchase materials and components for our products from many different suppliers, including both domestic and international sources. We develop close working relationships with our suppliers, many of whom have been supplying products to us for several years.

Research, Development, and Engineering

As part of our long-term strategy, we are committed to supporting our customers by providing research, development, and engineering services. These services allow us to facilitate in optimizing new product designs, and the production processes of our customers' programs.

Research, development, and engineering (RD&E) expenses consist principally of employee related costs, third party development costs, program materials costs, depreciation, and allocated information technology and facilities costs.

Competition

The market for the products and services we provide is highly competitive. There are numerous competitors in the EMS industry, many of which have substantially more resources and are more geographically diverse than we are. Some of our competitors have similar international production capabilities, large financial resources and some have substantially greater manufacturing, research and development, and marketing resources. There is also competition from the manufacturing operations of our current and potential customers, who are continually evaluating the merits of manufacturing their products internally versus the advantages of outsourcing. We believe that we can currently compete favorably in these areas primarily on the basis of our international footprint, responsiveness, creativity, vertical production capability, quality, and cost.

Trademarks

Our name and logo are federally registered trademarks, and we believe they are valuable assets of our business. We operate under the trade name “KeyTronicEMS” to better identify our primary business concentration in contract manufacturing in the EMS industry.

Employees

We consider our employees to be our primary strength and we make considerable efforts to maintain a well-qualified workforce. Our employee benefits include bonus programs involving periodic payments to all employees based on meeting quarterly or fiscal year performance targets. We regularly provide transportation, medical services, and meals to all of our employees in foreign locations. The Company also has defined contribution plans available to U.S. employees who have attained age 21 and provide group health, life, and disability insurance plans. We also maintain share based compensation plans and other long term incentive plans for certain employees and outside directors.

As of July 2, 2016 we had 4,947 employees compared to 4,866 on June 27, 2015, and 3,343 on June 28, 2014. Since we can have significant fluctuations in product demand, we seek to maintain flexibility in our workforce by utilizing skilled temporary and short-term contract labor in our manufacturing facilities in addition to full-time employees.

6

Backlog

On July 30, 2016 our order backlog was valued at approximately $122.2 million, compared to approximately $115.2 million on July 24, 2015. The amount of backlog is not necessarily indicative of future sales but can be indicative of trends in expected future sales revenue. Due to the relationships with our customers, we will occasionally allow orders to be canceled or rescheduled and as a result it is not a meaningful indicator of future financial results. If there are canceled or rescheduled orders, we typically negotiate fees to cover the costs we have incurred. Order backlog consists of purchase orders received for products expected to be shipped approximately within the next twelve months, although shipment dates are subject to change due to design modifications, customer forecast changes, or other customer requirements.

Foreign Markets

Information concerning net sales and long-lived assets (property, plant, and equipment) by geographic areas is set forth in Note 12, “Enterprise-Wide Disclosures” of the consolidated financial statements of this Annual Report on Form 10-K and that information is incorporated herein.

Executive Officers of the Registrant

The table below sets forth the name, current age and current position of our executive officers and other significant employees:

Name	Age	Positions Held
Executive Officers		
Craig D. Gates	57	President and Chief Executive Officer
Brett R. Larsen	43	Executive Vice President of Administration, Chief Financial Officer, and Treasurer
Douglas G. Burkhardt	58	Executive Vice President of Worldwide Operations
Philip S. Hochberg	54	Executive Vice President of Business Development
Lawrence J. Bostwick	64	Vice President of Engineering and Quality
Frank Crispigna III	55	Vice President of Materials
Duane D. Mackleit	48	Vice President of Program Management

Executive Officers

CRAIG D. GATES – President and Chief Executive Officer

Mr. Gates, age 57, has been President and Chief Executive officer of the Company since April 2009. Previously, he was Executive Vice President and General Manager from August 2002 to April 2009. He served as Executive Vice President of Marketing, Engineering and Sales from July 1997 to August 2002 and served as Vice President and General Manager of New Business Development from October 1995 to July 1997. He joined the Company as Vice President of Engineering in October of 1994. From 1982 to 1991 he held various engineering and management positions within the Microswitch Division of Honeywell, Inc., in Freeport, Illinois, and from 1991 to October 1994 he served as Director of Operations, Electronics for Microswitch. Mr. Gates has a Bachelor of Science Degree in Mechanical Engineering and a Masters in Business Administration from the University of Illinois, Urbana.

BRETT R. LARSEN – Executive Vice President of Administration, Chief Financial Officer, and Treasurer

Mr. Larsen, age 43, has served as Executive Vice President of Administration, Chief Financial Officer, and Treasurer since July 2015. Previously, he was Vice President of Finance and Controller from February 2010 to July 2015. He was Chief Financial Officer of FLSmidth Spokane, Inc. from December 2008 to February 2010. From October 2005 through November 2008, Mr. Larsen served as Controller of Key Tronic Corporation. From May 2004 to October 2005, Mr. Larsen served as Manager of Financial Reporting of Key Tronic Corporation. From 2002 to May 2004, Mr. Larsen was an audit manager for the public accounting firm BDO USA, LLP. He also held various auditing and supervisory positions with Grant Thornton LLP from 1997 to 2002. Mr. Larsen has a Bachelor of Science degree in Accounting and a Masters degree in Accounting from Brigham Young University and is a Certified Public Accountant.

DOUGLAS G. BURKHARDT – Executive Vice President of Worldwide Operations
Mr. Burkhardt, age 58, has been Executive Vice President of Worldwide Operations of the Company since July 2010. Previously Mr. Burkhardt was Vice President of Worldwide Operations from July 2008 to July 2010 and Director of China Operations and Program Management from January 2006 to July 2008. Mr. Burkhardt also served as Director of Northwest and China Operations from November of 1998 to January of 2006. Mr. Burkhardt also served as Director of Customer Satisfaction from March 1997 to November 1998 and Director of Molding from September of 1995 to March of 1997. Prior to this, Mr. Burkhardt served in other various senior management positions within the Company. Mr. Burkhardt has been with the Company since May of 1989. Prior to joining Key Tronic, Mr. Burkhardt worked for House of Aluminum and Glass for 12 years where he was the plant manager.
PHILIP S. HOCHBERG – Executive Vice President of Business Development
Mr. Hochberg, age 54, has been Executive Vice President of Business Development since July 2012. Prior to this, Mr. Hochberg served as Vice President of Business Development from October 2009 through June 2012. He was Director of Business Development and Program Management from July 2008 to October 2009. Mr. Hochberg served as Director of Business Development from October 2004 to July 2008 and as Director of EMS Sales and Marketing from July 2000 to October 2004. Prior to joining Key Tronic, Mr. Hochberg worked for Quinton Instrument Company as their Director of Marketing and Product Management from 1992 to 2000. From 1988 to 1992, he was employed by SpaceLabs Medical as their Business Development Marketing Manager. Mr. Hochberg has an MBA from the University of British Columbia, a BA in Psychology, with a minor in Business from Washington University in St. Louis.
LAWRENCE J. BOSTWICK – Vice President of Engineering and Quality
Mr. Bostwick, age 64, has been Vice President of Engineering and Quality since July 2008. Previously he was Director of Engineering and Quality from February 2007 to July 2008 and served as Corporate Director of Quality from February 2006 to February 2007. From 2003 to 2006 he was Director of Supply Chain Management and Quality for the Lancer Corporation and from 1998 to 2003 he was Vice President of Operations for Thermacore International. He is a graduate of the Westinghouse and General Electric – Engineering and Manufacturing Professional Development Programs. He is certified in both Quality and Industrial Engineering and is a Lean – Six Sigma Master Black Belt. Mr. Bostwick has a combined B.S. degree in Production and Operation and Industrial Engineering from Bowling Green State University and a Masters degree in Industrial Engineering and Business Administration from Syracuse University.
FRANK CRISPIGNA III – Vice President of Materials
Mr. Crispigna, age 55, has been Vice President of Materials of the company since October 2011. Prior to this, Mr. Crispigna held a variety of Materials and Supply Chain positions at Plexus Corporation since 1997, most recently serving as the Director – Supply Chain Solutions from 2005 - 2011. He has a Masters degree in Business Administration, and a Bachelor of Business Administration Degree in Marketing from the University of Wisconsin – Oshkosh. Mr. Crispigna also is a C.P.M., and received his certification in Supply Chain Leadership from the University of Wisconsin.
DUANE D. MACKLEIT – Vice President of Program Management
Mr. Mackleit, age 48, has been Vice President of Program Management of the company since July 2012. He served as Director of Program Management from July 2008 through June 2012. From May 2006 to July 2008 he served as Principal Program Manager. Prior to that, he served as Program Manager from March 2002 to May 2006 and Associate Program Manager from August 2000 to March 2002. Mr. Mackleit has also held several other positions with Key Tronic Corporation. Mr. Mackleit has an AA in Business from Spokane Falls Community College and a BA in Business/Marketing from Eastern Washington University. He also holds a MBA from Gonzaga University.
Available Information
Our principal executive offices are located at 4424 North Sullivan Road, Spokane Valley, Washington 99216, and our telephone number is (509) 928-8000. Our website is located at http://www.keytronic.com where filings of our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q or current reports on Form 8-K are available after they have been filed with the Securities and Exchange Commission. The information presented on our website currently and in the future is not considered to be part of this document or any document incorporated by reference in this document.

8

Item 1A. RISK FACTORS
There are risks and uncertainties that could affect our business. These risks and uncertainties include but are not limited to, the risk factors described below, in Item 7A: "Quantitative and Qualitative Disclosures about Market Risk" and elsewhere in this Form 10-K.
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 other similar expressions are intended to identify forward-looking statements.
We may experience fluctuations in quarterly results of operations.
Our quarterly operating results have varied in the past and may vary in the future due to a variety of factors, including adverse changes in the U.S. and global macroeconomic environment, volatility in overall demand for our customers' products, success of customers' programs, timing of 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 education, consumer products, 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. Conversely, our customers may abruptly lower or cancel production which may lead to a sudden, unexpected increase in inventory or accounts receivable for which we may not be reimbursed even when under contract with customers. 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 a 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, stock-based compensation, the valuation allowance on deferred tax assets, valuation of goodwill, impairment of long-lived assets, long-term incentive compensation accrual, the provision for warranty costs, the impact of hedging activities and purchase price allocation.
We are exposed to general economic conditions, which could have a material adverse impact on our business, operating results and financial condition.
Adverse economic conditions and uncertainty in the global economy such as unstable global financial and credit markets, inflation, and recession can negatively impact our business. Unfavorable economic conditions could affect the demand for our customers' products by triggering a reduction in orders as well as a decline in 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 effect on our financial results.
The majority of our sales come from a small number of customers and a decline in sales to any of these customers could adversely affect our business.
At present, our customer base is concentrated and could become more or less concentrated. 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, typically 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. The contraction in demand from certain industries could impact our customer orders and have a negative impact on our operations over the foreseeable future. Additionally, if one or more of our customers were to

become insolvent or otherwise unable to pay for the manufacturing services provided by us, our operating results and financial condition would be adversely affected.

We depend on a limited number of suppliers for certain components that are critical to our manufacturing processes. A shortage of these components or an increase in their price could interrupt our operations and result in a significant change in our results of operations.

We are dependent on many suppliers, including sole source suppliers, to provide key components and raw materials used in manufacturing customers’ products. We have seen supply shortages in certain electronic components. In addition, our suppliers' facilities may also experience earthquakes, tsunamis and other natural disasters which may cause a shortage of components. This can result in longer lead times and the inability to meet our customers request for flexible production and extended shipment dates. If demand for components outpaces supply, capacity delays could affect future operations. Delays in deliveries from suppliers or the inability to obtain sufficient quantities of components and raw materials could cause delays or reductions in shipment of products to our customers which could adversely affect our operating results and damage customer relationships.

We operate in a highly competitive industry; if we are not able to compete effectively in the EMS industry, our business could be adversely affected.

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 and processes 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.

Cash and cash equivalents are exposed to concentrations of credit risk.

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

Our ability to secure and maintain sufficient credit arrangements is key to our continued operations.

There is no assurance that we will be able to retain or renew our credit agreements in the future. In the event the business grows rapidly or the uncertain macroeconomic climate continues, additional financing resources could be necessary in the current or future fiscal years. There is no assurance that we will be able to obtain equity or debt financing at acceptable terms, or at all in the future. For a summary of our banking arrangements, see Note 4 Long-Term Debt of the “Notes to Consolidated Financial Statements.”

Our operations may be subject to certain risks.

We manufacture product in facilities located in Mexico, China and the United States. These operations may be subject to a number of risks, including:

- difficulties in staffing, turnover and managing onshore and offshore operations;
- political and economic instability (including acts of terrorism, pandemics, civil unrest, forms of violence and outbreaks of war), which could impact our ability to ship, manufacture, and/or receive product;
- unexpected changes in regulatory requirements and laws;
- longer customer payment cycles and difficulty collecting accounts receivable;
- export duties, import controls and trade barriers (including quotas);
- governmental restrictions on the transfer of funds;
- burdens of complying with a wide variety of foreign laws and labor practices;
- our locations may be impacted by hurricanes, tornadoes, earthquakes, water shortages, tsunamis, floods, typhoons, fires, extreme weather conditions and other natural or man-made disasters.

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

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

Fluctuations in foreign currency exchange rates could increase our operating costs.
We have manufacturing operations located in Mexico and China. A significant portion of our operations are denominated in the Mexican peso and the Chinese currency, the renminbi ("RMB"). Currency exchange rates fluctuate daily as a result of a number of factors, including changes in a country's political and economic policies. Volatility in the currencies of our entities and the United States dollar could seriously harm our business, operating results and financial condition. The primary impact of currency exchange fluctuations is on the cash, receivables, payables and expenses of our operating entities. As part of our hedging strategy, we currently use Mexican peso forward contracts to hedge foreign currency fluctuations for a portion of our Mexican peso denominated expenses. We currently do not hedge expenses denominated in RMB. Unexpected losses could occur from increases in the value of these currencies relative to the United States dollar.
Our success will continue to depend to a significant extent on our 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 production employees. There can be no assurance that we will be successful in attracting and retaining such personnel, particularly in our manufacturing locales that may be experiencing high demand for similar key personnel. The loss of key employees could have a material adverse effect on our business, operating results and financial condition.
If we are unable to maintain our technological and manufacturing process expertise, our business could be adversely affected.
The markets for our customers' products is characterized by rapidly changing technology, evolving industry standards, frequent new product introductions and 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.
Start-up costs and inefficiencies related to new or transferred programs can adversely affect our operating results and such costs may not be recoverable if such new programs or transferred programs are canceled.
Start-up costs, the management of labor and equipment resources in connection with the establishment of new programs and new customer relationships, and the need to obtain required resources in advance can adversely affect our gross margins and operating results. These factors are particularly evident in the ramping stages of new programs. These factors also affect our ability to efficiently use labor and equipment. We are currently managing a number of new programs. Consequently, our exposure to these factors has increased. In addition, if any of these new programs or new customer relationships were terminated, our operating results could be harmed, particularly in the short term. We may not be able to recoup these start-up costs or replace anticipated new program revenues.
Customers may change production timing and demand schedules which makes it difficult for us to schedule production and capital expenditures and to maximize the efficiency of our manufacturing capacity.
Changes in demand for customer products reduce our ability to accurately estimate the future requirements of our customers. This makes it difficult to schedule production and maximize utilization of our manufacturing capacity. We must determine the levels of business that we will seek and accept from customers, set production schedules, commit to procuring inventory, and allocate personnel and resources, based on our estimates of our customers' requirements. Customers can require sudden increases and decreases in production which can put added stress on resources and reduce margins. Sudden decreases in production can lead to excess inventory on hand which may or may not be reimbursed by our customers even when under contract.
Continued growth could further lead to capacity constraints. We may need to transfer production to other facilities, acquire new facilities, or outsource production which could negatively impact gross margin.
An adverse change in the interest rates for our borrowings could adversely affect our financial condition.
We are exposed to interest rate risk under our revolving line of credit and term loan. We currently hedge a portion of our term loan with an interest rate swap. We have not historically hedged the interest rate on our credit facility;

therefore, unless we do so, significant changes in interest rates could adversely affect our results of operations. Refer to the discussion in note 4, "Long-Term Debt" to the consolidated financial statements for further details of our debt obligations. We are also exposed to interest rate risk on our factoring activities.

Compliance or the failure to comply with current and future environmental laws or regulations could cause us significant expense.

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.

Our stock price is volatile.

Holders of the common stock will suffer immediate dilution to the extent outstanding equity awards are exercised to purchase common stock. 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.

Due to inherent limitations, there can be no assurance that our system of disclosure and internal controls and procedures will be successful in preventing all errors, theft and fraud, or in informing management of all material information in a timely manner.

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. Due to the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and may not be detected.

If we do not manage our growth effectively, our profitability could decline.

Our business is experiencing rapid growth which can place considerable additional demands upon our management team and our operational, financial and management information systems. Our ability to manage growth effectively requires us to continue to implement and improve these systems; avoid cost overruns; maintain customer, supplier and other favorable business relationships during possible transition periods; continue to develop the management skills of our managers and supervisors; and continue to train, motivate and manage our employees. Our failure to effectively manage growth could have a material adverse effect on our results of operations.

If our manufacturing processes and services do not comply with applicable statutory and regulatory requirements, or if we manufacture products containing design or manufacturing defects, demand for our services may decline and we may be subject to liability claims.

We manufacture and design products to our customers' specifications, and, in some cases, our manufacturing processes and facilities may need to comply with applicable statutory and regulatory requirements. For example, medical devices that we manufacture or design, as well as the facilities and manufacturing processes that we use to produce them, are regulated by the Food and Drug Administration and non-U.S. counterparts of this agency. In addition, our customers' products and the manufacturing processes that we use to produce them often are highly complex. As a result, products that we manufacture may at times contain manufacturing or design defects, and our manufacturing processes may be subject to errors or not be in compliance with applicable statutory and regulatory requirements. Defects in the products we manufacture or design, whether caused by a design, manufacturing or component failure or error, or deficiencies in our manufacturing processes, may result in delayed shipments to customers or reduced or canceled customer orders. If these defects or deficiencies are significant, our business reputation may also be damaged. The failure of the products that we manufacture or our manufacturing processes and facilities to comply with applicable statutory and regulatory requirements may subject us to legal fines or penalties and, in some cases, require us to shut down or incur considerable expense to correct a manufacturing process or facility. Our customers are required to indemnify us against liability associated with designing products to meet their specifications. However, if our customers are responsible for the defects, they may not, or may not have resources to, assume responsibility for any costs or liabilities arising from these defects, which could expose us to additional liability claims.

Energy price increases may negatively impact our results of operations.

Certain components that we use in our manufacturing process are petroleum-based. In addition, we, along with our suppliers and customers, rely on various energy sources in our transportation activities. While significant uncertainty currently exists about the future levels of energy prices, a significant increase is possible. Increased energy prices could cause an increase to our raw material costs and transportation costs. In addition, increased transportation costs of certain of our suppliers and customers could be passed along to us. We may not be able to increase our product prices enough to offset these increased costs. In addition, any increase in our product prices may reduce our future customer orders and profitability.

Disruptions to our information systems, including security breaches, losses of data or outages, could adversely affect our operations.

We rely on information technology networks and systems to process, transmit and store electronic information. In particular, we depend on our information technology infrastructure for a variety of functions, including worldwide financial reporting, inventory management, procurement, invoicing and email communications. Any of these systems may be susceptible to outages due to fire, floods, power loss, telecommunications failures, terrorist attacks and similar events. Despite the implementation of network security measures, our systems and those of third parties on which we rely may also be vulnerable to computer viruses, break-ins and similar disruptions. If we or our vendors are unable to prevent such outages and breaches, our operations could be disrupted.

We are involved in various legal proceedings.

In the past, we have been notified of claims relating to various matters including contractual matters, intellectual property rights or other issues arising in the ordinary course of business. In the event of such a claim, we may be required to spend a significant amount of money to defend or otherwise address the claim. Any litigation, even where a claim is without merit, could result in substantial costs and diversion of resources. Accordingly, the resolution or adjudication of such disputes, even those encountered in the ordinary course of business, could have a material adverse effect on our business, consolidated financial conditions and results of operations.

Increases in our own market capitalization and changes in securities laws and regulations will increase our costs and risk of noncompliance.

As a result of our increased market capitalization as of the end of our second quarter of fiscal year 2013, we are required to file as an accelerated filer. As such, we are subject to additional requirements contained in the Sarbanes-Oxley Act of 2002 (the Sarbanes-Oxley Act) and more recently the Dodd-Frank Act. The Sarbanes-Oxley and Dodd-Frank Acts required or will require changes in some of our corporate governance, securities disclosure and compliance practices. In response to the requirements of the Sarbanes-Oxley and Dodd-Frank Acts, the SEC and NASDAQ promulgated new rules and additional rulemaking is expected in the future. Compliance with these new rules and future rules has increased and may increase further our legal, financial and accounting costs as well as a potential risk of noncompliance. Absent significant changes in related rules, which we cannot assure, we anticipate some level of increased costs related to these new regulations to continue indefinitely. We also expect these developments to make it more difficult and more expensive to obtain director and officer liability insurance, and we may be forced to accept reduced coverage or incur substantially higher costs to obtain coverage. Likewise, these developments may make it more difficult for us to attract and retain qualified members of our Board of Directors or qualified management personnel. Further, the costs associated with the compliance with and implementation of procedures under these and future laws and related rules could have a material impact on our results of operations. In addition, the costs associated with noncompliance with additional securities laws and regulations could also impact our business.

We may encounter complications with acquisitions, which could potentially harm our business.

Any current or future acquisitions may require additional equity financing, which could be dilutive to our existing shareholders, or additional debt financing, which could potentially affect our credit ratings. Any downgrades in our credit ratings associated with an acquisition could adversely affect our ability to borrow by resulting in more restrictive borrowing terms. To integrate acquired businesses, we must implement our management information systems, operating systems and internal controls, and assimilate and manage the personnel of the acquired operations. The integration of acquired businesses may be further complicated by difficulties managing operations in geographically dispersed locations. The integration of acquired businesses may not be successful and could result in disruption by diverting management’s attention from the core business. In addition, the integration of acquired businesses may require that we incur significant restructuring charges or other increases in our expenses and working capital requirements, which reduce our return on invested capital.

Acquisitions may involve numerous other risks and challenges including but not limited to: potential loss of key employees and customers of the acquired companies; the potential for deficiencies in internal controls at acquired companies; lack of experience operating in the geographic market or industry sector of the acquired business; constraints on available liquidity, and exposure to unanticipated liabilities of acquired companies. These and other factors could harm our ability to achieve anticipated levels of profitability at acquired operations or realize other anticipated benefits of an acquisition, and could adversely affect our consolidated business and operating results.

Our goodwill and identifiable intangible assets could become impaired, which could reduce the value of our assets and reduce net income in the year in which the write-off occurs.

Goodwill represents the excess of the cost of an acquisition over the fair value of the net assets acquired. The Company also ascribes value to certain identifiable intangible assets, which consists of customer relationships, non-compete agreements, and favorable leases, as a result of the acquisitions of Sabre and Ayrshire. The Company may incur impairment charges on goodwill or identifiable intangible assets if it determines that the fair values of goodwill or identifiable intangible assets are less than their current carrying values. The Company evaluates, on a regular basis, whether events or circumstances have occurred that indicate all, or a portion, of the carrying amount of goodwill may no longer be recoverable, in which case an impairment charge to earnings would become necessary. Refer to Notes 1 and 15 to the consolidated financial statements and critical accounting policies and estimates' in management's discussion and analysis of financial condition and results of operations for further discussion regarding the impairment testing of goodwill and identifiable intangible assets.

A decline in general economic conditions or global equity valuations could impact the judgments and assumptions about the fair value of the Company's businesses and the Company could be required to record impairment charges on its goodwill or other identifiable intangible assets in the future, which could impact the Company's consolidated balance sheet, as well as the Company's consolidated statement of operations. If the Company was required to recognize an impairment charge in the future, the charge would not impact the Company's consolidated cash flows, current liquidity, capital resources, and covenants under its existing credit facilities.

Item 1B. UNRESOLVED STAFF COMMENTS

None

Item 2. PROPERTIES AS OF DATE OF FILING

We have manufacturing and sales operations located in the United States, Mexico, and China. The table below lists the locations and square footage of our operating facilities:

Location	Approx. Sq. Ft.	Type of Interest (Leased/Owned)	Description of Use
Spokane Valley, Washington	95,000	Leased	Sales, research, administration and manufacturing
Spokane Valley, Washington	36,000	Leased	Manufacturing
Oakdale, Minnesota	60,000	Leased	Manufacturing and warehouse
Louisville, Kentucky	4,000	Leased	Administration
Harrodsburg, Kentucky (1)	22,000	Owned	Manufacturing and warehouse
Corinth, Mississippi	350,000	Leased	Manufacturing and warehouse
Fayetteville, Arkansas	175,000	Leased	Manufacturing and warehouse
El Paso, Texas	80,000	Leased	Shipping and warehouse
Total USA	822,000		
Juarez, Mexico	174,000	Owned	Manufacturing
Juarez, Mexico	60,000	Owned	Manufacturing and warehouse
Juarez, Mexico	66,000	Owned	Manufacturing and warehouse
Juarez, Mexico	115,000	Owned	Manufacturing and warehouse
Juarez, Mexico	103,000	Owned	Manufacturing and warehouse
Juarez, Mexico	193,000	Leased	Warehouse
Juarez, Mexico	66,000	Leased	Manufacturing
Juarez, Mexico	72,000	Leased	Manufacturing
Total Mexico	849,000		
Shanghai, China	121,000	Leased	Manufacturing and warehouse
Shanghai, China	36,000	Leased	Manufacturing
Total China	157,000		
Grand Total	1,828,000		

(1) During fiscal year 2016, we announced the closing of the Harrodsburg, Kentucky location which is expected to be completed by the first quarter of fiscal year 2017. We plan to list the facility for sale during fiscal year 2017.

The geographic diversity of these locations allows us to offer services near certain of our customers and major electronics markets with the additional benefit of reduced labor costs. We consider the productive capacity of our current facilities sufficient to carry on our current business. In addition, in Juarez, Mexico one of our buildings includes adjacent vacant land that could be developed into additional manufacturing and warehouse space.

All of our facilities are ISO certified to ISO 9001:2008 standards, ISO-14001 environmental standards, ISO-13485:2003 medical devices standards, AS9100C aviation, space and defense standards, ISO/TS 16949 automotive standards, ANSI/ESD S20.20-2007 Electrostatic Discharge Control Program and to Customs Trade Partnership against Terrorism (CTPAT). The Spokane, Washington facilities are additionally registered ISO/IEC 80079-34 explosive atmospheres and by the US State Department for International Traffic in Arms Regulations (ITAR). The Shanghai, China facilities are registered/certified to IS/TS 16949 automotive standard, ISO 13485 medical devices and ISO 14001 environmental. Additionally, Juarez, Mexico is registered by the NSF for water products. The Oakdale, Minnesota; Corinth, Mississippi; Fayetteville, Arkansas and Harrodsburg, Kentucky facilities are all registered by the U.S. State Department for International Traffic in Arms Regulations (ITAR).

Item 3. LEGAL PROCEEDINGS

We are a party to certain lawsuits or claims in the ordinary course of business. We do not believe that these proceedings, individually or in the aggregate, will have a material adverse effect on our financial position, results of operations or cash flow.

Item 4. MINE SAFETY DISCLOSURES

Not Applicable

PART II

Item 5: MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED SHAREHOLDER MATTERS, AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

Our common stock is traded on the NASDAQ Global Market, formerly the NASDAQ National Market System under the symbol "KTCC." Quarterly high and low sales prices for our common stock for fiscal years 2016 and 2015 were as follows:

	2016		2015	
	High	Low	High	Low
First Quarter	$11.15	$9.75	$11.50	$9.90
Second Quarter	10.39	7.50	10.75	7.50
Third Quarter	8.47	6.09	10.75	7.85
Fourth Quarter	8.97	6.99	12.49	10.39

High and low stock prices are based on the daily sales prices reported by the NASDAQ Stock Market. These quotations represent prices between dealers without adjustment for markups, markdowns, and commissions, and may not represent actual transactions.

Holders and Dividends

As of July 2, 2016, we had 706 shareholders of common stock on record. As a result of our credit agreement with Wells Fargo Bank, N.A. we are restricted from declaring or paying dividends in cash or stock without the Bank's prior written consent. We have not paid a cash dividend and do not anticipate payment of dividends in the foreseeable future.

Equity Compensation Plan Information

Information concerning securities authorized for issuance under our equity compensation plans is set forth in Part III, Item 12 of this Annual Report, under the caption "Securities Authorized for Issuance under Equity Compensation Plans", and that information is incorporated herein by reference.

Performance Graph

Set forth below is a line graph comparing the cumulative total shareholder return on our common stock with the cumulative total return of the NASDAQ Stock Market (U.S. & Foreign) Index and the NASDAQ Electronic Components Index in fiscal 2016.

	7/2/2011	6/30/2012	6/29/2013	6/28/2014	6/27/2015	7/2/2016
Key Tronic Corporation	100.00	182.30	228.98	237.39	235.84	163.50
NASDAQ Composite	100.00	108.58	128.19	169.08	192.10	187.57
NASDAQ Electronic Components	100.00	97.46	109.01	152.85	161.74	170.59

Item 6: SELECTED FINANCIAL DATA

The following selected data is derived from our audited consolidated financial statements and should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations," the consolidated financial statements and related notes, and other information included in this report.

Financial Highlights

(In thousands, except for Supplemental Data and Per Share Amounts)

	Fiscal Year Ended				
	July 2, 2016	June 27, 2015 (3)	June 28, 2014(3)	June 29, 2013	June 30, 2012
Consolidated Statements of Operations Data:					
Net sales	$484,965	$433,997	$305,394	$361,033	$346,475
Gross profit	38,825	33,305	26,854	34,512	29,836
Gross margin percentage	8.0 %	7.7 %	8.8 %	9.6 %	8.6 %
Operating income	10,416	6,653	9,304	18,126	14,351
Operating margin percentage	2.1 %	1.5 %	3.0 %	5.0 %	4.1 %
Net income	6,533	4,304	7,613	12,583	11,626
Earnings per share – diluted	0.58	0.38	0.67	1.12	1.07
Consolidated Cash Flow Data:					
Cash flows provided by (used in) operations	4,580	7,667	1,458	29,282	(5,066)
Capital expenditures	13,277	8,808	7,763	3,470	4,654
Consolidated Balance Sheet Data:					
Net working capital (1)	97,349	98,318	71,049	73,827	76,236
Total assets	235,924	230,794	156,660	135,130	150,912
Long-term liabilities	46,232	43,237	848	3,030	19,050
Shareholders' equity	105,582	100,768	103,645	94,160	78,608
Book value per share (2)	$9.84	$9.42	$9.83	$8.97	$7.50
Supplemental Data:					
Number of shares outstanding at year-end	10,725,349	10,706,136	10,546,750	10,502,188	10,481,356
Number of employees at year-end	4,947	4,866	3,343	2,584	2,700
Approximate square footage of operational facilities	1,828,000	1,892,000	1,139,000	1,011,000	945,000

(1) Net working capital is defined as total current assets less total current liabilities. Net working capital measures the portion of current assets that are financed by long term funds and is an indicator of short term financial management.

(2) Book value per share is defined as total shareholders' equity divided by the number of shares outstanding at the end of the fiscal year.

(3) Reflects the acquisition of Ayrshire on September 3, 2014 in fiscal year 2015 and Sabre on July 1, 2013 in fiscal year 2014.

Item 7: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

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

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

Executive Summary

We're pleased with how our business rebounded from several unusual challenges in the first two quarters and finished with strong revenue and earnings growth for fiscal year 2016. The continued ramp of new programs and our investment in improving our operations to accommodate a more diversified customer base drove the overall improvement in fiscal 2016. At the same time, we won a number of new significant programs throughout the year, including new programs involving home automation, industrial metering, industrial lighting, consumer products, telecommunications and security equipment.

Net sales of $485.0 million for fiscal year 2016 increased by 11.7 percent as compared to net sales of $434.0 million in fiscal year 2015. The increase in net sales was primarily driven by an increase in revenue related to new program wins as well as the inclusion of Ayrshire for the entire fiscal year 2016, partially offset by a decrease in demand from a single longstanding customer. Moving into the first quarter of fiscal year 2017, we expect to see a slight decline in revenue due to the disengagement from a few small programs and our decision to disengage completely from a longstanding customer that adversely impacted our business throughout the year. For the first quarter of fiscal year 2017, the Company expects to report revenue in the range of $117 million to $122 million. Future results will depend on actual levels of customers' orders, the timing of the start-up of production of new product programs and the potential impact of the macroeconomic uncertainty. We believe that we are well positioned in the EMS industry to continue expansion of our customer base and continue long-term growth.

We continue to diversify our customer base by adding additional programs and customers. Our current customer relationships involve a variety of products, including consumer electronics, electronic storage devices, plastics, household products, gaming devices, specialty printers, telecommunications, industrial equipment, military supplies, computer accessories, medical, educational, irrigation, automotive, transportation management, robotics, RFID, power supply, off-road vehicle equipment, fitness equipment, HVAC controls, consumer products, home building products, material handling systems and lighting equipment.

Gross profit as a percent of net sales was 8.0 percent in fiscal year 2016 compared to 7.7 percent for the prior fiscal year. The increase in gross profit as a percentage of net sales was primarily related to a decrease in material related costs partially offset by an increase in certain overhead costs. The level of gross margin is impacted by product mix, timing of the startup of new programs, facility utilization, pricing within the electronics industry and material costs, which can fluctuate significantly from quarter to quarter and year to year.

Operating income as a percentage of net sales for fiscal year 2016 was 2.1 percent compared to 1.5 percent for fiscal year 2015. The increase in operating income as a percentage of net sales was primarily due to an increase in gross profit as discussed above.

Net income for fiscal year 2016 was $6.5 million or $0.58 per diluted share, as compared to net income of $4.3 million or $0.38 per diluted share for fiscal year 2015. The increase in net income for fiscal year 2016 as compared to fiscal year 2015 was primarily driven by an increase in net revenue and gross margin as described above.

19

We maintain a strong balance sheet with a current ratio of 2.2 and a debt to equity ratio of 0.42. Total cash provided by operating activities as defined on our cash flow statement was $4.6 million during fiscal year 2016. We maintain sufficient liquidity for our expected future operations. As of July 2, 2016, we had $18.1 million outstanding on our revolving line of credit with Wells Fargo Bank, N.A. As a result, $26.5 million remained available to borrow as of July 2, 2016. We believe cash flow from operations, our borrowing capacity, our accounts receivable sale program, and equipment financing should provide adequate capital for planned growth over the long term.

RESULTS OF OPERATIONS

Comparison of the Fiscal Year Ended July 2, 2016 with the Fiscal Year Ended June 27, 2015

The following table sets forth for the periods indicated certain items of the consolidated statements of income expressed as a percentage of net sales. The financial information and discussion below should be read in conjunction with the consolidated financial statements and notes contained in this Annual Report.

	Fiscal Year Ended					
	July 2, 2016	% of net sales	June 27, 2015	% of net sales	$ change	% point change
Net sales	$484,965	100.0%	$433,997	100.0%	$50,968	—
Cost of sales	446,140	92.0	400,692	92.3	45,448	(0.3)
Gross profit	38,825	8.0	33,305	7.7	5,520	0.3
Operating expenses:						
Research, development and engineering	6,397	1.3	5,784	1.3	613	—
Selling, general and administrative	22,012	4.5	20,868	4.8	1,144	(0.3)
Total operating expenses	28,409	5.8	26,652	6.1	1,757	(0.3)
Operating income	10,416	2.1	6,653	1.5	3,763	0.6
Interest expense, net	2,265	0.4	1,353	0.3	912	0.1
Income before income taxes	8,151	1.7	5,300	1.2	2,851	0.5
Income tax provision	1,618	0.4	996	0.2	622	0.2
Net income	$6,533	1.3%	$4,304	1.0%	$2,229	0.3
Effective income tax rate	19.9 %		18.8 %			

Net Sales

The increase in net sales of $51.0 million from prior year was primarily driven by new program wins and to a lesser degree an increase in demand from current customers and the inclusion of Ayrshire for a full year of operations.

The following table shows the revenue by industry sectors as a percentage of revenue for fiscal years 2016 and 2015:

	Fiscal Year Ended	
	July 2, 2016	June 27, 2015
Industrial	39%	34%
Consumer	31	28
Communication	13	16
Gaming	7	6
Printers	6	6
Transportation	3	8
Computer and Peripheral	1	2
Total	100%	100%

We provide services to customers in a number of industries and produce a variety of products for our customers in each industry. Key Tronic does not target any particular industry, but rather seeks to find programs that strategically fit our vertical manufacturing capabilities. As we continue to diversify our customer base and win new customers, we will continue to see a change in the industry concentrations of our revenue.

Sales to foreign locations represented 28.3 percent and 30.4 percent of our total net sales in fiscal years 2016 and 2015, respectively.

Cost of Sales

Total cost of sales as a percentage of net sales was 92.0 percent and 92.3 percent in fiscal years 2016 and 2015, respectively.

Total cost of materials as a percentage of net sales was approximately 63.9 percent and 64.6 percent in fiscal years 2016 and 2015, respectively. The change from year-to-year is primarily a result of improved pricing of certain raw materials as well as a more favorable product mix.

Production and support costs as a percentage of net sales were 28.1 percent and 27.7 percent in fiscal years 2016 and 2015, respectively. The increase in fiscal year 2016 is primarily related to inefficiencies associated with ramping production of new products that resulted in higher than expected operating expenses during the first half of fiscal year 2016.

We provide a reserve for obsolete and non-saleable inventories based on specific identification of inventory against current demand and recent usage. We also consider our customers' ability to pay for inventory whether or not there is a lead-time assurance agreement for a specific program. The amounts charged to expense for these inventories were approximately $0.8 million and $0.5 million in fiscal years 2016 and 2015, respectively.

We provide warranties on certain products we sell and estimate warranty costs based on historical experience and anticipated product returns. Warranty expense is related to workmanship claims on keyboards and EMS products. The amounts charged to expense are determined based on an estimate of warranty exposure. The net warranty expense was approximately $95,000 and $115,000 in fiscal years 2016 and 2015, respectively.

Gross Profit

Gross profit as a percentage of net sales was 8.0 percent and 7.7 percent in fiscal years 2016, and 2015, respectively. The 0.3 percentage point increase in gross profit as a percentage of net sales during fiscal year 2016 as compared to fiscal year 2015 is primarily related to a 1.2 percentage point decrease in material related costs partially offset by a 0.9 percentage point increase in certain overhead costs.

Changes in gross profit margins reflect the impact of a number of factors that can vary from period to period, including product mix, start-up costs and efficiencies associated with new programs, product life cycles, sales volumes, capacity utilization of our resources, management of inventories, component pricing and shortages, end market demand for customers' products, fluctuations in and timing of customer orders, and competition within the EMS industry. These and other factors can cause variations in operating results. There can be no assurance that gross margins will not decrease in future periods.

We took early pay discounts to suppliers that totaled approximately $1.9 million and $1.5 million in fiscal years 2016 and 2015, respectively. Early pay discounts will fluctuate based on our liquidity and changes in the discounts and terms offered by our suppliers.

Research, Development and Engineering

Research, development and engineering expenses (RD&E) consists principally of employee related costs, third party development costs, program materials, depreciation and allocated information technology and facilities costs. Total RD&E expenses were $6.4 million and $5.8 million in fiscal years 2016 and 2015, respectively. Total RD&E expenses as a percent of net sales were 1.3 percent in fiscal years 2016 and 2015, respectively.

Selling, General and Administrative

Selling, general and administrative expenses (SG&A) consist principally of salaries and benefits, advertising and marketing programs, sales commissions, travel expenses, provision for doubtful accounts, facilities costs, and professional services. Total SG&A expenses were $22.0 million and $20.9 million in fiscal years 2016 and 2015, respectively. Total SG&A expenses as a percent of net sales were 4.5 percent and 4.8 percent in fiscal years 2016 and 2015, respectively. This 0.3 percentage point decrease in SG&A as a percentage of net sales is primarily related to approximately $0.8 million of non-recurring closing costs associated with the Ayrshire acquisition incurred during fiscal year 2015.

Interest Expense

We had net interest expense of $2.3 million and $1.4 million in fiscal years 2016 and 2015, respectively. The increase in interest expense is primarily related to the inclusion of a full year of the term loan balance outstanding and an increase in the average balance outstanding on our line of credit which was primarily used to fund growth in operations.

Income Tax Provision

We had an income tax expense of $1.6 million during fiscal year 2016 as compared to an income tax expense of $1.0 million in fiscal year 2015. The income tax expense recognized during both fiscal years 2016 and 2015, was primarily a function of U.S., federal, state and foreign taxes recognized at the statutory rates offset by the net benefit associated with federal research and development tax credits and changes in potential foreign tax credits.

We continually review our requirements for liquidity domestically to fund current operations, revenue growth and to look for potential future acquisitions. We anticipate repatriating a portion of our unremitted foreign earnings. The estimated taxes and associated foreign tax credits are included in the income tax calculation. For further information on taxes please review footnote 6 of the "Notes to Consolidated Financial Statements."

International Subsidiaries

We offer customers a complete global manufacturing solution. Our facilities provide our customers the opportunity to have their products manufactured in the facility that best serves specific cost, product manufacturing and distribution needs. The locations of active foreign subsidiaries are as follows:

- Key Tronic Juarez, SA de CV owns five facilities and leases three facilities in Juarez, Mexico. These facilities include an SMT facility, an assembly and molding facility, a sheet metal fabrication facility, and assembly and storage facilities. This subsidiary is primarily used to support our U.S. operations.
- Key Tronic Computer Peripherals (Shanghai) Co., Ltd. leases two facilities with SMT, assembly, global purchasing and warehouse capabilities in Shanghai, China, which began operations in 1999. Its primary function is to provide EMS services for export; however, it is also currently manufacturing certain electronic keyboards.

Foreign sales (based on shipping instructions) from our worldwide operations, including domestic exports, were $137.4 million and $132.1 million in fiscal years 2016 and 2015, respectively. Products and manufacturing services provided by our subsidiary operations are often shipped to customers directly by the parent company.

RESULTS OF OPERATIONS

Comparison of the Fiscal Year Ended June 27, 2015 with the Fiscal Year Ended June 28, 2014

The following table sets forth for the periods indicated certain items of the consolidated statements of income expressed as a percentage of net sales. The financial information and discussion below should be read in conjunction with the consolidated financial statements and notes contained in this Annual Report.

	Fiscal Year Ended					
	June 27, 2015	% of net sales	June 28, 2014	% of net sales	$ change	% point change
Net sales	$433,997	100.0%	$305,394	100.0%	$128,603	—
Cost of sales	400,692	92.3	278,540	91.2	122,152	1.1
Gross profit	33,305	7.7	26,854	8.8	6,451	(1.1)
Operating expenses:						
Research, development and engineering	5,784	1.3	5,586	1.8	198	(0.5)
Selling, general and administrative	20,868	4.8	11,964	3.9	8,904	0.9
Total operating expenses	26,652	6.1	17,550	5.7	9,102	0.4
Operating income	6,653	1.5	9,304	3.0	(2,651)	(1.5)
Interest expense, net	1,353	0.3	81	—	1,272	0.3
Income before income taxes	5,300	1.2	9,223	3.0	(3,923)	(1.8)
Income tax provision	996	0.2	1,610	0.5	(614)	(0.3)
Net income	$4,304	1.0%	$7,613	2.5%	$(3,309)	(1.5)
Effective income tax rate	18.8%		17.5%			

Net Sales

The increase in net sales from prior year was primarily driven by an approximate $124.6 million increase in revenue related to Ayrshire and by an approximate $17.3 million increase in revenues related to new program wins, partially offset by an approximate $7.0 million decrease in revenue related to decreased demand from current customer programs and an approximate $6.3 million decrease in revenue related to program losses.

The following table shows the revenue by industry sectors as a percentage of revenue for fiscal years 2015 and 2014:

	Fiscal Year Ended	
	June 27, 2015	June 28, 2014
Industrial and Commercial Printer	34%	17%
Consumer	28	30
Communication	16	23
Transportation	8	—
Gaming	6	15
Transaction Printer	6	11
Computer and Peripheral	2	4
Total	100%	100%

We provide services to customers in a number of industries and produce a variety of products for our customers in each industry. As we continue to diversify our customer base and win new customers we may continue to see a change in the industry concentrations of our revenue.

Sales to foreign locations outside the United States represented 30.4 percent and 35.3 percent of our total net sales in fiscal years 2015 and 2014, respectively.

Cost of Sales

Total cost of sales as a percentage of net sales was 92.3 percent and 91.2 percent in fiscal years 2015 and 2014, respectively.

Total cost of materials as a percentage of net sales was approximately 64.6 percent and 64.5 percent in fiscal years 2015 and 2014, respectively. The change from year-to-year was relatively flat and resulted from an increase in material cost as a percentage of net sales from certain customers which were partially offset by the lower material costs as a percentage of net sales from Ayrshire customers.

Production and support costs as a percentage of net sales were 27.7 percent and 26.7 percent in fiscal years 2015 and 2014, respectively. The increase in fiscal year 2015 is primarily related to inefficiencies associated with ramping production of new products that resulted in higher than expected operating expenses during the first quarter of fiscal year 2015.

We provide a reserve for obsolete and non-saleable inventories based on specific identification of inventory against current demand and recent usage. We also consider our customers' ability to pay for inventory whether or not there is a lead-time assurance agreement for a specific program. The amounts charged to expense for these inventories were approximately $0.5 million and $0.3 million in fiscal years 2015 and 2014, respectively.

We provide warranties on certain products we sell and estimate warranty costs based on historical experience and anticipated product returns. Warranty expense is related to workmanship claims on keyboards and EMS products. The amounts charged to expense are determined based on an estimate of warranty exposure. The net warranty expense was approximately $115,000 and $35,000 in fiscal years 2015 and 2014, respectively.

Gross Profit

Gross profit as a percentage of net sales was 7.7 percent and 8.8 percent in fiscal years 2015, and 2014, respectively. The 1.1 percentage point decrease in gross profit as a percentage of net sales during fiscal year 2015 as compared to fiscal year 2014 is primarily related to a 1.0 percentage point increase in certain overhead costs and a 0.1 percentage point increase in material costs.

Changes in gross profit margins reflect the impact of a number of factors that can vary from period to period, including product mix, start-up costs and efficiencies associated with new programs, product life cycles, sales volumes, capacity utilization of our resources, management of inventories, component pricing and shortages, end market demand for customers’ products, fluctuations in and timing of customer orders, and competition within the EMS industry. These and other factors can cause variations in operating results. There can be no assurance that gross margins will not decrease in future periods.

We took early pay discounts to suppliers that totaled approximately $1.5 million and $1.1 million in fiscal years 2015 and 2014, respectively. Early pay discounts will fluctuate based on our liquidity and changes in the discounts and terms offered by our suppliers.

Research, Development and Engineering

Research, development and engineering expenses (RD&E) consists principally of employee related costs, third party development costs, program materials, depreciation and allocated information technology and facilities costs. Total RD&E expense was $5.8 million and $5.6 million in fiscal years 2015 and 2014, respectively. Total RD&E expenses as a percent of net sales were 1.3 percent and 1.8 percent in fiscal years 2015 and 2014, respectively. This 0.5 percentage point decrease in RD&E as a percentage of net sales is primarily related to the increase in revenue as a result of the Ayrshire acquisition as well as a slight decrease in certain overhead expenses.

Selling, General and Administrative

Selling, general and administrative expenses (SG&A) consist principally of salaries and benefits, advertising and marketing programs, sales commissions, travel expenses, provision for doubtful accounts, facilities costs, and professional services. Total SG&A expenses were $20.9 million and $12.0 million in fiscal years 2015 and 2014, respectively. Total SG&A expenses as a percent of net sales were 4.8 percent and 3.9 percent in fiscal years 2015 and 2014, respectively. This 0.9 percentage point increase in SG&A as a percentage of net sales is primarily related to the inclusion of Ayrshire’s SG&A costs, non-recurring closing costs associated with the Ayrshire acquisition, and an increase in payroll related costs.

Interest Expense

We had net interest expense of $1.4 million and $0.1 million in fiscal years 2015 and 2014, respectively. This increase in interest expense is primarily related to an increase in the average balance outstanding on our line of credit, term loan and factored receivables that were primarily used for the acquisition of Ayrshire.

Income Tax Provision

We had an income tax expense of $1.0 million during fiscal year 2015 as compared to an income tax expense of $1.6 million in fiscal year 2014. The income tax expense recognized during both fiscal years 2015 and 2014 was primarily a function of U.S. and foreign taxes recognized at the statutory rates offset by the net benefit associated with federal research and development tax credits, changes in potential foreign tax credits and changes in foreign tax regimes. The impact of this offset was greater in 2014 because the Company recognized a one-time benefit related to the repeal of the IETU tax regime in Mexico during fiscal year 2014.

We continually review our requirements for liquidity domestically to fund current operations, revenue growth and to look for potential future acquisitions. We anticipate repatriating a portion of our unremitted foreign earnings. The estimated taxes and associated foreign tax credits are included in the income tax calculation. For further information on taxes please review footnote 6 of the "Notes to Consolidated Financial Statements."

Capital Resources and Liquidity

Operating Cash Flow

Net cash provided by operating activities for fiscal year 2016 was $4.6 million compared to net cash provided by operating activities of $7.7 million and $1.5 million in fiscal years 2015 and 2014, respectively.

The $4.6 million of net cash provided by operating activities during fiscal year 2016 is primarily related to $6.5 million of net income, $6.2 million of depreciation and amortization and an $11.1 million decrease in accounts receivable offset by a $16.2 million increase in inventory and a $2.6 million decrease in accounts payable. The $7.7 million of net cash provided by operating activities during fiscal year 2015 was primarily due to $4.3 million of net income, $5.9 million of depreciation and amortization and an $18.0 million increase in accounts payable partially offset by a $14.7 million increase in inventory, a $2.1 million increase in accounts receivable and a $4.2 million increase in other assets. The $1.5 million of cash provided by operating activities during fiscal year 2014 was primarily due to $7.6 million of net income, $3.8 million of depreciation and amortization and a $6.1 million increase in accounts payable partially offset by a $10.5 million increase in inventory, a $2.7 million increase in accounts receivable and a $3.1 million increase in other assets.

Accounts receivable fluctuates based on the timing of shipments, terms offered and collections. In addition, accounts receivable will fluctuate based upon the amount of accounts receivable sold under our Trade Accounts Receivable Purchase Program. During fiscal year 2016 and fiscal year 2015 we factored receivables of $78.0 million and $12.1 million, respectively, from accounts receivable sold to financial institutions, which are not included on our Consolidated Balance Sheets. We did not have our Trade Accounts Receivable Purchase Program during fiscal year 2014. We purchase inventory based on customer forecasts and orders, and when those forecasts and orders change, the amount of inventory may also fluctuate. Accounts payable fluctuates with changes in inventory levels, volume of inventory purchases, negotiated supplier terms, and taking advantage of early pay discounts.

Investing Cash Flow

Cash flows used in investing activities were $5.7 million, $48.1 million, and $13.8 million in fiscal years 2016, 2015 and 2014, respectively. Our primary investing activity during fiscal year 2016 was the purchase of property and equipment. Our primary investing activities during fiscal years 2015 and 2014 were the acquisitions of Ayrshire and Sabre, respectively, as discussed in further detail in footnote 14 of the "Notes to Consolidated Financial Statements."

Operating and capital 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 and available borrowing capacities. During fiscal years 2016 and 2015 we received $13.3 million and $8.8 million of cash resulting from the sale and leaseback of equipment under operating leases, respectively. We did not enter into sale and leaseback transactions during fiscal year 2014.

Financing Cash Flow

On September 3, 2014, we entered into an amended credit agreement which provided the Company with a term loan in the amount of $35.0 million. As of July 2, 2016, our credit agreement with Wells Fargo Bank N.A. provided a revolving line of credit facility of up to $45 million, subject to availability.

Cash flows provided by financing activities were $1.7 million in fiscal year 2016 as compared to cash flows provided by financing activities of $35.0 million and $7.3 million in fiscal years 2015 and 2014, respectively. Our primary financing activities during fiscal year 2016 were repayments on our term loan of $5.0 million as well as borrowings and repayments under our revolving line of credit facility. Our primary financing activities during fiscal year 2015 were borrowings on our term loan of $31.3 million, net of repayments related to the Ayrshire acquisition, borrowings and repayments under our revolving line of credit facility and net repayments of $7.9 million related to the accounts receivable transfer program with Wells Fargo Bank N.A. Our primary financing activities in fiscal year 2014 were borrowings and repayments under our revolving line of credit facility, principal payments on our capital lease obligations and $7.9 million in cash as a result of our accounts receivable transfer program with Wells Fargo Bank N.A.

25

As of July 2, 2016, the Company had an outstanding balance on the line of credit of $18.1 million. We had availability to borrow an additional $26.5 million under the Wells Fargo line of credit and we were in compliance with our loan covenants. 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 fixed asset financing will be sufficient to meet our working and fixed capital requirements for the foreseeable future.

As of July 2, 2016, we had approximately $1.0 million of cash held by foreign subsidiaries. If cash is to be repatriated in the future from these foreign subsidiaries, the Company could be subject to additional income taxes payable in the U.S. The total amount of U.S. taxes required to be paid for the amount of foreign subsidiary cash on hand as of July 2, 2016 would approximate $100,000. The Company also has approximately $25.4 million of foreign earnings that have not been repatriated to the U.S. Of that amount, the Company estimates that $11.9 million is to be repatriated in the future, requiring U.S. taxes of $1.2 million that is currently accrued in our deferred tax liabilities. The remaining $13.5 million is considered to be permanently reinvested in Mexico and China. If these amounts were required to be repatriated it would create an additional $2.1 million in U.S. tax liability.

Contractual Obligations and Commitments

In the normal course of business, we enter into contracts which obligate us to make payments in the future. The table below sets forth our significant future obligations by fiscal year:

Payments Due by Fiscal Year (in thousands)

	Total	2017	2018	2019	2020	2021	Thereafter
Term loan (1)	$26,250	$5,000	$5,000	$5,000	$11,250	$—	$ —
Wells Fargo Bank N.A. revolving loan (2)	$18,073	$—	$—	$—	$18,073	$—	$ —
Operating leases (3)	$18,385	$7,666	$5,831	$2,805	$1,261	$732	$ 90
Purchase orders (4)							

(1) The terms of the Wells Fargo Bank N.A. term loan are discussed in the consolidated financial statements at Note 4, "Long-Term Debt." Principal on the term loan is payable in equal quarterly installments of $1.25 million commencing on December 15, 2014 and continuing through June 15, 2019, with final installment of all remaining unpaid principal due on August 31, 2019.

(2) The terms of the Wells Fargo Bank N.A. revolving loan are discussed in the consolidated financial statements at Note 4, "Long-Term Debt." As of July 2, 2016, we were in compliance with our loan covenants. Breaching these covenants could have resulted in a material impact on our operations or financial condition and could impact our ability to borrow under this facility in the future.

(3) We maintain vertically integrated manufacturing operations in the United States, Mexico and China. We lease some of our administrative and manufacturing facilities and equipment. A complete discussion of properties can be found in Part 1, Item 2 at "Properties." Leases have proven to be an acceptable method for us to acquire new or replacement equipment and to maintain facilities with a minimum impact on our short term cash flows for operations. In addition, such operations are heavily dependent upon technically superior manufacturing equipment including molding machines in various tonnages, Surface Mount Technology (SMT) lines, sheet metal fabrication and stamping machines, clean rooms, and automated insertion, and test equipment for the various products we are capable of producing.

(4) As of July 2, 2016, we had open purchase order commitments for materials and other supplies of approximately $42.3 million. Included in the open purchase orders are various blanket orders for annual requirements. Actual needs under these blanket purchase orders fluctuate with our manufacturing levels and as such cannot be broken out between fiscal years. In addition, we have contracts with many of our customers that minimize our exposure to losses for material purchased within lead-times necessary to meet customer forecasts. Purchase orders generally can be cancelled without penalty within specified ranges that are determined in negotiations with our suppliers. These agreements depend in part on the type of materials purchased as well as the circumstances surrounding any requested cancellations.

In addition to the cash requirements presented above, we have various other accruals which are not included in the table above. For example, we owe our suppliers approximately $59.0 million for accounts payable and shipments in transit at the end of the fiscal year. We generally pay our suppliers in a range from 30 to 120 days depending on terms offered. These payments are financed by operating cash flows and our revolving line of credit.

We believe that cash flows generated from operations, factoring, leasing facilities, and funds available under the revolving credit facility will satisfy cash requirements for a period in excess of 12 months and into the foreseeable future.

Critical Accounting Policies and Estimates

Preparation of our consolidated financial statements requires management to make estimates and assumptions that affect the reported amount of assets, liabilities, revenues and expenses. Note 1 to our consolidated financial statements describes the significant accounting policies used in the preparation of our consolidated financial statements. Management believes the most complex and sensitive judgments, because of their significance to our consolidated financial statements, result primarily from the need to make estimates about effects of matters that are inherently uncertain. The most significant areas involving management judgments are described below. Actual results in these areas could differ from management's estimates.

Revenue

Sales revenue from manufacturing is recognized upon shipment of the manufactured product per contractual terms. Upon shipment, title transfers and the customer assumes risks and rewards of ownership of the product. The price to the buyer is fixed or determinable and recoverability is reasonably assured. Unless specifically stated in contractual terms, there are no formal customer acceptance requirements or further obligations related to the manufacturing services; if any such requirements exist, then sales revenue is recognized at the time when such requirements are completed and such obligations are fulfilled. Revenue is recorded net of estimated returns of manufactured product based on management's analysis of historical returns.

Revenues and associated costs from engineering design, development services and tooling, which are performed under contract of short term durations, are recognized only after the completed performance of the service.

Inactive, Obsolete, and Surplus Inventory Reserve

Inventories are stated at the lower of cost or market. Cost is determined principally using the first-in, first-out (FIFO) method. 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, customer purchase orders, 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 or purchase orders, we are usually covered by lead-time assurance agreements or purchase orders 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. We also reserve for inventory related to specific customers covered by lead-time assurance agreements when those customers are experiencing financial difficulties or reimbursement is not reasonably assured.

Allowance for Doubtful Accounts

We value our accounts receivable net of an allowance for doubtful accounts. As of July 2, 2016 and June 27, 2015, the allowance for doubtful accounts was approximately $0.1 million, respectively. 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. 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

Income tax expense includes U.S. and international income taxes and the provision for U.S. taxes on undistributed earnings of foreign subsidiaries not deemed to be permanently invested. We do not record U.S. tax liabilities on undistributed earnings of international subsidiaries that are deemed to be permanently reinvested. Certain income and expenses are not reported in tax returns and financial statements in the same year. The tax effect of such temporary differences is reported as deferred income taxes. The deferred income taxes are classified as long-term assets or liabilities. The most significant areas involving management judgments include deferred income tax assets and liabilities, uncertain tax positions, and research and development tax credits. Our estimates of the realization of the deferred tax assets related to our tax credits are based upon our estimates of future taxable income which may change.

Stock-Based Compensation

Stock-based compensation is accounted for according to Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 718, Compensation—Stock Compensation. ASC 718 requires us to expense the fair value of employee stock options, stock appreciation rights and other forms of stock-based compensation. Under the fair value recognition provisions of ASC 718, share-based compensation cost is estimated at the grant date based upon the fair value of the award and is recognized as expense ratably over the requisite service period of the award (generally the vesting period). Determining the appropriate fair value model and calculating the fair value of share-based awards requires judgment, including estimating the expected life of the share-based award, the expected stock price volatility over the expected life of the share-based award and forfeitures.

To determine the fair value of stock based awards on the date of grant we use the Black-Scholes option-pricing model. Inherent in this model are assumptions related to expected stock price volatility, option life, risk-free interest rate and dividend yield. The risk-free interest rate is a less-subjective assumption as it is based on factual data derived from public sources. We use a dividend yield of zero as we have never paid cash dividends and have no intention to pay cash dividends in the foreseeable future. The expected stock price volatility and option life assumptions require a greater level of judgment. Our expected stock-price volatility assumption is based upon the historical volatility of our stock which is obtained from public data sources. The expected life represents the weighted average period of time that share-based awards are expected to be outstanding, giving consideration to vesting schedules and historical exercise patterns. We determine the expected life assumption based upon the exercise and post-vesting behavior that has been exhibited historically, adjusted for specific factors that may influence future exercise patterns. If expected volatility or expected life were to increase, that would result in an increase in the fair value of our stock options which would result in higher compensation charges, while a decrease in volatility or the expected life would result in a lower fair value of our stock option awards resulting in lower compensation charges.

We estimate forfeitures for all of our awards based upon historical experience of stock-based pre-vesting forfeitures. We believe that our estimates are based upon outcomes that are reasonably likely to occur. If actual forfeitures are higher than our estimates it would result in lower compensation expense and to the extent the actual forfeitures are lower than our estimate we would record higher compensation expense.

Impairment of Long-Lived Assets

Long-lived assets, such as property, plant, and equipment are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated undiscounted future cash flows, an impairment charge would be recognized in the amount by which the carrying amount of the asset exceeds the fair value of the asset.

Derivatives and Hedging Activity

Derivatives are recognized on the balance sheet at their estimated fair value. On the date a derivative contract is entered into, the Company designates the derivative as a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability (a “cash flow” hedge). The Company does not enter into derivatives for speculative purposes. Changes in the fair value of a derivative that qualifies as a cash flow hedge are recorded in “Accumulated Other Comprehensive Income,” until earnings are affected by the variability of cash flows. See Note 11 of the Company’s consolidated financial statements for additional information.

Long-Term Incentive Compensation Accrual

Long-term incentive compensation is recognized as expense ratably over the requisite service period of the award which is generally three years. The Board of Directors approve target performance measures for the three year period for each of the Company’s officers and non-employee Directors. Performance measures are based on a combination of sales growth targets and return on invested capital targets. No cash awards will be made to participants if actual Company performance does not exceed the minimum target performance measures. The calculation used to determine the necessary accrual uses a combination of actual results and projected results. We believe that our estimates are based upon outcomes that are reasonably likely to occur. These estimates and assumptions are based on historical results as well as future expectations. Actual results could vary from our estimates and assumptions.

Impairment of Goodwill

In accordance with ASC 350, Goodwill and Other Intangible Assets, goodwill is not amortized but is required to be reviewed for impairment at least annually or when events or circumstances indicate that carrying value may exceed fair value. The Company is permitted the option to first assess qualitative factors to determine whether the existence of events and circumstances indicates that it is more likely than not that the fair value of any reporting unit is less than its corresponding carrying value. If, after assessing the totality of events and circumstances, the Company concludes that it is not more likely than not that the fair value of any reporting unit is less than its corresponding carrying value then the Company is not required to take further action. However, if the Company concludes otherwise, then it is required to perform a quantitative impairment test, including computing the fair value of the reporting unit and comparing that value to its carrying value. If the fair value is less than its carrying value, a second step of the test is required to determine if recorded goodwill is impaired. In the event that goodwill is impaired, an impairment charge to earnings would become necessary. The Company also has the option to bypass the qualitative assessment for goodwill in any period and proceed directly to performing the quantitative impairment test.

Business Combinations

The Company recognizes the assets acquired and liabilities assumed in business combinations on the basis of their fair values at the date of acquisition. We assess the fair value of assets, including intangible assets, using a variety of methods and each asset is measured at fair value from the perspective of a market participant. The method used to estimate the fair values of intangible assets incorporates significant assumptions regarding the estimates a market participant would make in order to evaluate an asset, including a market participant's use of the asset and the appropriate discount rates for a market participant. Assets recorded from the perspective of a market participant that are determined to not have economic use for us are expensed immediately. Any excess purchase price over the fair value of the net tangible and intangible assets acquired is allocated to goodwill. Transaction costs and restructuring costs associated with a business combination are expensed as incurred.

New and Future Accounting Pronouncements

See Note 1 to our consolidated financial statements.

Item 7A: 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 and term loan are secured by substantially all of our assets. The interest rates applicable to our revolving credit facility and term loan fluctuate with the Wells Fargo Bank N.A. prime rate and LIBOR rates. There was outstanding $18.1 million in borrowings under our revolving credit facility and $26.3 million outstanding on our term loan as of July 2, 2016. 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 and term loan.

Our only material interest rate risk is associated with our revolving credit facility and term loan. During the second quarter of fiscal year 2015, we entered into an interest rate swap contract with a notional amount of $25.0 million related to the borrowings outstanding under the term loan and revolving credit facility. As of July 2, 2016, the remaining notional amount of the interest rate swap contract was $20.5 million. Through the use of the interest rate swap, as described above, we fixed the basis on which we pay interest, thus eliminating much of our interest rate risk. See Note 11 – "Derivative Financial Instruments" to the Consolidated Financial Statements for additional information regarding our derivative instruments.

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 was $69.4 million of foreign currency forward contracts outstanding as of July 2, 2016. The fair value of these contracts was approximately $(11.0) million. See Note 11 – "Derivative Financial Instruments" to the Consolidated Financial Statements for additional information regarding our derivative instruments.

29

Item 8: FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA
Report of Independent Registered Public Accounting Firm
Board of Directors and Stockholders
Key Tronic Corporation
Spokane Valley, Washington
We have audited the accompanying consolidated balance sheets of Key Tronic Corporation as of July 2, 2016 and June 27, 2015 and the related consolidated statements of income, comprehensive income (loss), shareholders' equity, and cash flows for each of the three years in the period ended July 2, 2016. In connection with our audits of the financial statements, we have also audited the financial statement schedule listed in the accompanying index. These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.
We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.
In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Key Tronic Corporation at July 2, 2016 and June 27, 2015, and the results of its operations and its cash flows for each of the three years in the period ended July 2, 2016, in conformity with accounting principles generally accepted in the United States of America.
Also, in our opinion, the financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Key Tronic Corporation's internal control over financial reporting as of July 2, 2016, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated September 9, 2016 expressed an unqualified opinion thereon.

/s/ BDO USA, LLP

Spokane, Washington
September 9, 2016

KEY TRONIC CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In thousands)

	July 2, 2016	June 27, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	$1,018	$372
Trade receivables, net of allowance for doubtful accounts of $135 and $97	61,678	72,852
Inventories, net	107,006	91,594
Other	11,757	13,646
Total current assets	181,459	178,464
Property, plant and equipment, net	27,925	26,974
Other assets:		
Deferred income tax asset	8,982	6,723
Other	1,673	1,621
Goodwill	9,957	9,957
Other intangible assets, net	5,928	7,055
Total other assets	26,540	25,356
Total assets	$235,924	$230,794
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$58,967	$61,528
Accrued compensation and vacation	9,571	9,467
Current portion of debt	5,000	5,000
Other	10,572	10,794
Total current liabilities	84,110	86,789
Long-term liabilities:		
Term loan	21,250	26,250
Revolving loan	18,073	11,631
Deferred income tax liability	—	501
Other long-term obligations	6,909	4,855
Total long-term liabilities	46,232	43,237
Total liabilities	130,342	130,026
Commitments and contingencies (Note 4 and 9)		
Shareholders' equity:		
Common stock, no par value—shares authorized 25,000; issued and outstanding 10,725 and 10,706 shares, respectively	45,227	44,136
Retained earnings	67,928	61,395
Accumulated other comprehensive loss	(7,573)	(4,763)
Total shareholders' equity	105,582	100,768
Total liabilities and shareholders' equity	$235,924	$230,794

See accompanying notes to consolidated financial statements.

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

	Fiscal Year Ended		
	July 2, 2016	June 27, 2015	June 28, 2014
Net sales	$484,965	$433,997	$305,394
Cost of sales	446,140	400,692	278,540
Gross profit	38,825	33,305	26,854
Research, development and engineering expenses	6,397	5,784	5,586
Selling, general and administrative expenses	22,012	20,868	11,964
Total operating expenses	28,409	26,652	17,550
Operating income	10,416	6,653	9,304
Interest expense, net	2,265	1,353	81
Income before income taxes	8,151	5,300	9,223
Income tax provision	1,618	996	1,610
Net income	$6,533	$4,304	$7,613
Net income per share — Basic	$0.61	$0.41	$0.72
Weighted average shares outstanding — Basic	10,710	10,572	10,528
Net income per share — Diluted	$0.58	$0.38	$0.67
Weighted average shares outstanding — Diluted	11,278	11,286	11,358

See accompanying notes to consolidated financial statements.

KEY TRONIC CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(In thousands)

	Fiscal Year Ended		
	July 2, 2016	June 27, 2015	June 28, 2014
Comprehensive income (loss):			
Net income	$6,533	$4,304	$7,613
Other comprehensive income (loss):			
Unrealized (loss) gain on hedging instruments, net of tax	(2,810)	(7,166)	1,090
Comprehensive income (loss)	$3,723	$(2,862)	$8,703

Other comprehensive income (loss) for fiscal years 2016, 2015, and 2014 is reflected net of tax (benefit) provision of approximately $(1.4) million, $(3.7) million and $0.6 million, respectively.
See accompanying notes to consolidated financial statements.

33

KEY TRONIC CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Fiscal Year Ended		
	July 2, 2016	June 27, 2015	June 28, 2014
Operating activities:			
Net income	$6,533	$4,304	$7,613
Adjustments to reconcile net income to cash provided by operating activities:			
Depreciation and amortization	6,162	5,910	3,829
Excess tax benefit from exercise of stock options	(402)	(50)	(73)
Provision for obsolete inventory	757	520	257
Provision for warranty	95	115	35
Provision for doubtful accounts	38	97	37
Loss on disposal of property, plant and equipment	—	70	12
Share-based compensation expense	764	732	659
Deferred income taxes	(1,313)	(1,517)	(687)
Changes in operating assets and liabilities, net of acquisition:			
Trade receivables	11,136	(2,080)	(2,686)
Inventories	(16,169)	(14,708)	(10,450)
Other assets	1,739	(4,249)	(3,145)
Accounts payable	(2,561)	17,999	6,059
Accrued compensation and vacation	104	(283)	149
Other liabilities	(2,303)	807	(151)
Cash provided by operating activities	4,580	7,667	1,458
Investing activities:			
Payment for acquisition, net of cash acquired	—	(47,964)	(6,027)
Purchases of property and equipment	(13,277)	(8,808)	(7,763)
Proceeds from sale of property and equipment	7,612	8,641	—
Cash used in investing activities	(5,665)	(48,131)	(13,790)
Financing activities:			
Payment of financing costs	(113)	(62)	(84)
Proceeds from issuance of long term debt	—	35,000	—
Repayments of long term debt and capital lease obligations	(5,000)	(3,750)	(576)
Borrowings under revolving credit agreement	197,568	137,987	8,212
Repayment of revolving credit agreement	(191,126)	(126,356)	(8,212)
Proceeds from accounts receivable transfer agreement	—	1,116	7,853
Payments towards accounts receivable transfer agreement	—	(8,969)	—
Excess tax benefit from exercise of stock options	402	50	73
Proceeds from exercise of stock options	—	17	50
Cash provided by financing activities	1,731	35,033	7,316
Net increase (decrease) in cash and cash equivalents	646	(5,431)	(5,016)
Cash and cash equivalents, beginning of period	372	5,803	10,819
Cash and cash equivalents, end of period	$1,018	$372	$5,803
Supplemental cash flow information:			
Interest payments	$2,308	$1,221	$90
Income tax payments, net of refunds	$813	$3,274	$2,184

See accompanying notes to consolidated financial statements.

KEY TRONIC CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
(In thousands)

	Shares	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balances, June 29, 2013	10,502	$43,369	$49,478	$ 1,313	$ 94,160
Net income	—	—	7,613	—	7,613
Unrealized gain on hedging instruments, net	—	—	—	1,090	1,090
Exercise of stock options	45	50	—	—	50
Share-based compensation	—	659	—	—	659
Excess tax benefit from share-based compensation	—	73	—	—	73
Balances, June 28, 2014	10,547	$44,151	$57,091	$ 2,403	$ 103,645
Net income	—	—	4,304	—	4,304
Unrealized loss on hedging instruments, net	—	—	—	(7,166)	(7,166)
Exercise of stock options	5	17	—	—	17
Exercise of stock appreciation rights	223	—	—	—	—
Shares withheld for taxes	(69)	(814)	—	—	(814)
Share-based compensation	—	732	—	—	732
Excess tax benefit from share-based compensation	—	50	—	—	50
Balances, June 27, 2015	10,706	$44,136	$61,395	$ (4,763)	$ 100,768
Net income	—	—	6,533	—	6,533
Unrealized loss on hedging instruments, net	—	—	—	(2,810)	(2,810)
Exercise of stock appreciation rights	28	—	—	—	—
Shares withheld for taxes	(9)	(75)	—	—	(75)
Share-based compensation	—	764	—	—	764
Excess tax benefit from share-based compensation	—	402	—	—	402
Balances, July 2, 2016	10,725	$45,227	$67,928	$ (7,573)	$ 105,582

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
1. SIGNIFICANT ACCOUNTING POLICIES
Business
Key Tronic Corporation and subsidiaries (the Company) is engaged in electronic manufacturing services (EMS) for original equipment manufacturers (OEMs) and also manufactures keyboards and other input devices. The Company’s headquarters are located in Spokane Valley, Washington with manufacturing operations in Oakdale, Minnesota; Fayetteville, Arkansas; Corinth, Mississippi; Harrodsburg, Kentucky; and foreign manufacturing operations in Juarez, Mexico; and Shanghai, China.
Principles of Consolidation
The consolidated financial statements include the Company and its wholly owned subsidiaries in the United States, Mexico and China. Intercompany balances and transactions have been eliminated during consolidation.
Reclassifications
Certain prior period reclassifications were made to conform with the current period presentation. These reclassifications had no effect on reported income, comprehensive income (loss), cash flows, total assets, or shareholders' equity as previously reported.
Use of Estimates
The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Estimates include the allowance for doubtful receivables, the provision for obsolete and non-saleable inventories, deferred tax assets and liabilities, uncertain tax positions, valuation of goodwill, impairment of long-lived assets, medical self-funded insurance liability, long-term incentive compensation accrual, the provision for warranty costs, the fair value of stock appreciation rights granted under the Company’s share-based compensation plan and purchase price allocation of acquired businesses. Due to uncertainties with respect to the assumptions and estimates, actual results could differ from those estimates.
Cash and Cash Equivalents
The Company considers investments with an original maturity of three months or less to be cash equivalents. Cash equivalents are carried at cost, which approximates fair value. The Company may have cash and cash equivalents at financial institutions that are in excess of federally insured limits from time to time.
Allowance for Doubtful Accounts
The Company evaluates the collectability of accounts receivable and records an allowance for doubtful accounts, which reduces the receivables to an amount that management reasonably estimates will be collected. A specific allowance is recorded against receivables considered to be impaired based on the Company’s knowledge of the financial condition of the customer. In determining the amount of the allowance, the Company considers several factors including the aging of the receivables, the current business environment and historical experience. After all attempts to collect a receivable have failed, the receivable is written off against the allowance.
Inventories
Inventories are stated at the lower of cost or market. Cost is determined principally using the first-in, first-out (FIFO) method. Customer orders are based upon forecasted quantities of product manufactured for shipment over defined periods. Raw material inventories are purchased to fulfill these customer requirements. Within these arrangements, customer demands for products frequently change, sometimes creating excess and obsolete inventories. The Company regularly reviews raw material inventories by customer for both excess and obsolete quantities. Wherever possible, the Company attempts to recover its full cost of excess and obsolete inventories from customers or, in some cases, through other markets. When it is determined that the Company’s carrying cost of such excess and obsolete inventories cannot be recovered in full, a charge is taken against income for the difference between the carrying cost and the estimated realizable amount. We also reserve for inventory related to specific customers covered by lead-time assurance agreements when those customers are experiencing financial difficulties or reimbursement is not reasonably assured.
Property, Plant and Equipment

Property, plant and equipment are carried at cost and depreciated using straight-line methods over the expected useful lives of the assets. Repairs and maintenance costs are expensed as incurred.

Business Combinations

The Company recognizes the assets acquired and liabilities assumed in business combinations on the basis of their fair values at the date of acquisition. We assess the fair value of assets, including intangible assets, using a variety of methods and each asset is measured at fair value from the perspective of a market participant. The method used to estimate the fair values of intangible assets incorporates significant assumptions regarding the estimates a market participant would make in order to evaluate an asset, including a market participant's use of the asset and the appropriate discount rates for a market participant. Assets recorded from the perspective of a market participant that are determined to not have economic use for us are expensed immediately. Any excess purchase price over the fair value of the net tangible and intangible assets acquired is allocated to goodwill. Transaction costs and restructuring costs associated with a business combination are expensed as incurred.

Impairment of Goodwill

The Company records intangible assets that are acquired individually or with a group of other assets in the financial statements at acquisition. In accordance with ASC 350, Goodwill and Other Intangible Assets, goodwill is not amortized but is required to be reviewed for impairment at least annually or when events or circumstances indicate that carrying value may exceed fair value. The Company tests goodwill by first performing a qualitative analysis ("Step 0") to determine if it is more likely than not that the fair value of the reporting unit is greater than its carrying value. If the Company determines that it is not more likely than not that the fair value of the reporting unit is greater than its carrying value, the Company calculates the fair value of the reporting unit and compares the fair value of the reporting unit to its carrying value ("Step 1"). If the carrying value of the reporting unit exceeds the fair value, goodwill is potentially impaired and the second step ("Step 2") of the impairment test must be performed. In the second step, the Company compares the implied fair value of the goodwill, as defined by ASC 350, to the carrying amount to determine the impairment loss, if any.

The Company performed its annual qualitative Step 0 analysis as of April 3, 2016 and determined a Step 1 analysis was necessary due to market conditions. Based on the results of the Step 1 analysis, the Company concluded that the fair value of the reporting unit was greater than the carrying value of the reporting unit based on a methodology that utilized both an income approach and a market approach. We considered valuation factors including the Company's market capitalization, future discounted cash flows and an estimated control premium based upon a review of comparable market transactions. We will continue to monitor our market capitalization and impairment indicators.

Impairment of Long-lived Assets

The Company, using its best estimates based on reasonable and supportable assumptions and projections, reviews assets for impairment whenever events or changes in circumstances have indicated that the carrying amount of its assets might not be recoverable. Impaired assets are reported at the lower of cost or fair value.

Accrued Warranty

An accrual is made for expected warranty costs, with the related expense recognized in cost of goods sold. Management reviews the adequacy of this accrual quarterly based on historical analyses and anticipated product returns.

Self-funded Insurance

The Company self-funds its domestic employee health plans. The Company contracts with a separate administrative service company to supervise and administer the programs and act as its representative. The Company reduces its risk under this self-funded platform by purchasing stop-loss insurance coverage for high dollar individual claims. In addition, if the aggregate annual claims amount to more than 125 percent of expected claims for the plan year this insurance will also pay those claims amounts exceeding that level.

The Company estimates its exposure for claims incurred but not paid at the end of each reporting period and uses historical claims data supplied by the Company's broker to estimate its self-funded insurance liability. This liability is subject to a total limitation that varies based on employee enrollment and factors that are established at each annual contract renewal. Actual claims experience may differ from the Company's estimates. Costs related to the administration of the plan and related claims are expensed as incurred.

Revenue Recognition

Sales revenue from manufacturing is recognized upon shipment of the manufactured product per contractual terms. Upon shipment, title transfers and the customer assumes risks and rewards of ownership of the product. The price to the buyer is fixed or determinable and recoverability is reasonably assured. Unless specifically stated in contractual terms, there are no formal customer acceptance requirements or further obligations related to the manufacturing services; if any such requirements exist, then sales revenue is recognized at the time when such requirements are completed and such obligations are fulfilled. Revenue is recorded net of estimated returns of manufactured product based on management’s analysis of historical returns.

Revenues and associated costs from engineering design, development services and tooling, which are performed under contract of short term durations, are recognized only after the completed performance of the service. Revenue from engineering design, development services and tooling represented approximately 1.7 percent, 2.5 percent and 3.4 percent of total revenue in fiscal years 2016, 2015, and 2014, respectively.

Shipping and Handling Fees

The Company classifies costs associated with shipping and handling fees as a component of cost of goods sold. Customer billings related to shipping and handling fees are reported as revenue.

Research, Development and Engineering

Research, development and engineering expenses include unreimbursed EMS costs as well as design and engineering costs associated with the production of EMS programs. Research, development and engineering costs are expensed as incurred.

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 provision. To date, we have not incurred charges for interest or penalties in relation to the underpayment of income taxes. The tax years 1997 through the present remain open to examination by the major U.S. taxing jurisdictions to which we are subject. Refer to Note 6 for further discussions.

Derivative Instruments and Hedging Activities

The Company has entered into foreign currency forward contracts and an interest rate swap 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 (AOCI) and is reclassified into earnings in the same period in which the underlying hedged transaction affects earnings. The derivative’s effectiveness represents the change in fair value of the hedge that offsets the change in fair value of the hedged item.

The Company uses derivatives to manage the variability of foreign currency fluctuations of expenses in our Mexico facilities and interest rate risk associated with certain borrowings under the Company’s debt arrangement. The foreign currency forward contracts and interest rate swaps have terms that are matched to the underlying transactions being hedged. As a result, these transactions fully offset the hedged risk and no ineffectiveness has been recorded.

The Company’s foreign currency forward contracts and interest rate swaps potentially expose the Company to credit risk to the extent the counterparties may be unable to meet the terms of the agreement. The Company minimizes such risk by seeking high quality counterparties. The Company’s counterparties to the foreign currency forward contracts and interest rate swaps 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 Company does not enter into derivative instruments for trading or speculative purposes.

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 stock options 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.

Foreign Currency Transactions

The functional currency of the Company’s subsidiaries in Mexico and China is the U.S. dollar. Realized foreign currency transaction gains and losses for local currency denominated assets and liabilities are included in cost of goods sold.

Fair Value of Financial Instruments

The carrying values of cash and cash equivalents, accounts receivable and current liabilities reflected on the balance sheets at July 2, 2016 and June 27, 2015, reasonably approximate their fair value. As of July 2, 2016, the Company had an outstanding balance on the line of credit of $18.1 million and term loan of $26.3 million. The carrying value of debt approximates fair value. As of June 27, 2015, the Company had an outstanding balance on the line of credit of $11.6 million and term loan of $31.3 million.

Share-based Compensation

The Company’s incentive plan may provide for equity and liability awards to employees in the form of stock options, stock appreciation rights, 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 included in cost of goods sold, research, development and engineering, 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.

Restructuring

Periodically the Company may consolidate excess facilities in order to maximize efficiencies and reduce its costs. In connection with these activities, we recognize restructuring charges for employee termination costs, exit costs and long-lived asset impairment when applicable.

The recognition of these restructuring charges require that we make certain judgments and estimates regarding the nature, timing and amount of costs associated with the planned exit activity. To the extent our actual results differ from our estimates and assumptions, we may be required to revise the estimates of future liabilities, requiring the recognition of additional restructuring charges or the reduction of liabilities already recognized. Such changes to previously estimated amounts may be material to the consolidated financial statements. At the end of each reporting period, we evaluate the remaining accrued balances to ensure that no excess accruals are retained and the utilization of the provisions are for their intended purpose in accordance with developed exit plans.

Newly Adopted and Recent Accounting Pronouncements

In May 2014, Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2014-09 (ASU 2014-09), Revenue from Contracts with Customers. The guidance in this Update affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance contracts or lease contracts). The standard's core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. In doing so, companies will need to use more judgment and make more estimates than under current guidance. This may include identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. The amendments in this Update are effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Early adoption is not permitted. Companies have the option of using either a full or modified retrospective approach in applying this standard. The Company is in the process of assessing the impact of ASU 2014-09 on its consolidated financial statements.

In July 2015, the FASB issued final guidance that simplifies the subsequent measurement of inventory for which cost is determined by methods other than last-in first-out (“LIFO”) and the retail inventory method. For inventory within the scope of the new guidance, entities will be required to compare the cost of inventory to only one measure, its net realizable value, and not the three measures required by the existing guidance. Net realizable value is the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation. The new guidance should not change how entities initially measure the cost of inventory. The guidance will be effective for the Company in the fiscal year beginning July 3, 2017. Early adoption is permitted. We have not yet determined the impact this new guidance may have on our financial statements.

In September 2015, the FASB issued Accounting Standards Update 2015-16 (ASU 2015-16), Simplifying the Accounting for Measurement-Period Adjustments. The amendments in this Update require that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The amendments in this Update require that the acquirer record, in the same period's financial statements, the effect on earnings of changes in depreciation, amortization, or other income effects, if any, as a result of the change to the provisional amounts, calculated as if the accounting had been completed at the acquisition date. The amendments of ASU 2015-16 did not have a significant impact on the Company's consolidated financial statements.

In November 2015, the FASB issued Accounting Standards Update 2015-17, Income Taxes. The amendments in this Update require that deferred tax liabilities and assets be classified as noncurrent in a classified statement of financial position. The guidance will be effective for the Company beginning after December 15, 2016, and interim periods within those annual periods. Earlier application is permitted for all entities. The Company retrospectively adopted this ASU during the second quarter of fiscal year 2016. The following table summarizes the adjustments made to conform prior period classifications with the new guidance (in thousands):

	June 27, 2015		
	As Filed	Reclass	As Adjusted
Current deferred income tax assets	$6,643	$(6,643)	$ —
Long-term deferred income tax assets	80	6,643	6,723
Long-term deferred income tax liabilities	(501)	—	(501)
Net deferred tax assets	$6,222	$—	$ 6,222

In February 2016, the FASB issued Accounting Standards Update 2016-02 (ASU 2016-02), Leases which supersedes ASC 840 Leases and creates a new topic, ASC 842 Leases. This update requires lessees to recognize a lease asset and a lease liability for all leases, including operating leases, with a term greater than 12 months on its balance sheet. The update also expands the required quantitative and qualitative disclosures surrounding leases. This update is effective for fiscal years beginning after December 15, 2018 and interim periods within those fiscal years, with earlier adoption permitted. This update will be applied using a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The Company is currently evaluating the effect of this update on its consolidated financial statements.

In March 2016, the FASB issued Accounting Standards Update 2016-09 (ASU 2016-09), Improvements to Employee Share-Based Payment Accounting. This update simplifies several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. This update is effective for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years, with earlier adoption permitted. The Company is currently evaluating the effect of this update on its consolidated financial statements.

In August 2016, the FASB issued Accounting Standards Update 2016-15 (ASU 2016-15), Classification of Certain Cash Receipts and Cash Payments. This update provides guidance on how to record eight specific cash flow issues. This update is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted and a retrospective transition method to each period should be presented. The Company is currently evaluating the effect of this update on its consolidated financial statements.

Fiscal Year

The Company operates on a 52/53 week fiscal year. Fiscal years end on the Saturday nearest June 30. As such, fiscal years 2016, 2015, and 2014, ended on July 2, 2016, June 27, 2015, and June 28, 2014, respectively. Fiscal year 2016 is a 53 week year whereas fiscal years 2015 and 2014 were 52 week years.

2. INVENTORIES

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

	July 2, 2016	June 27, 2015
Finished goods	$13,384	$8,019
Work-in-process	18,988	15,220
Raw materials and supplies	74,634	68,355
	$107,006	$91,594

3. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consists of the following:

	Life	July 2, 2016	June 27, 2015
	(in years)	(in thousands)	
Land	—	$2,940	$2,940
Buildings and improvements	3 to 30	23,737	23,134
Equipment	1 to 10	53,095	48,126
Furniture and fixtures	3 to 5	2,924	3,065
		82,696	77,265
Accumulated depreciation		(54,771)	(50,291)
		$27,925	$26,974

4. LONG-TERM DEBT

On September 3, 2014, the Company entered into an agreement with Wells Fargo Bank for a five-year term loan in the amount of $35.0 million which was used to acquire all of the outstanding shares of CDR Manufacturing, Inc. (dba Ayrshire Electronics). For further information on the acquisition of Ayrshire, see footnote 14 of the “Notes to Consolidated Financial Statements.” On August 6, 2015, the Company entered into a First Amendment to the amended and restated credit agreement extending the limit on our line of credit facility to $45.0 million as evidenced by the Second Replacement Revolving Note.

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 1.75%, LIBOR plus 2.0% or LIBOR plus 2.25% 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 and expires on August 31, 2019.

As of July 2, 2016, the Company had an outstanding balance under the credit facility of $18.1 million, $0.4 million in outstanding letters of credit and $26.5 million available for future borrowings. The interest rate on the outstanding line of credit balance was in the range of 2.45% - 3.50%. As of June 27, 2015, the Company had an outstanding balance under the credit facility of $11.6 million, $0.3 million in outstanding letters of credit and $18.0 million available for future borrowings. The interest rate on the outstanding line of credit balance was in the range of 2.28% - 3.25%.

The outstanding principal balance of the term loan bears interest at a fixed rate per annum of the daily one month LIBOR plus 1.75%, 2.00% or 2.25% depending on the ratio of the Company’s funded debt to EBITDA, except that the term loan bore interest at LIBOR plus 2.00% from September 3, 2014 through December 14, 2014 regardless of the Company’s cash flow leverage ratio. Principal on the term loan is payable in equal quarterly installments of $1.25 million commencing December 15, 2014 and continuing through June 15, 2019, with a final installment of all remaining unpaid principal due on August 31, 2019. The Company had an outstanding balance of $26.3 million under the term loan as of July 2, 2016. As of June 27, 2015, the Company had an outstanding balance of $31.3 million under the term loan.

Debt maturities as of July 2, 2016 for the next five years and thereafter are as follows (in thousands):

Fiscal Years Ending	Amount
2017	$5,000
2018	5,000
2019	5,000
2020	29,323
2021	—
Thereafter	—
Total debt payments	$44,323

The Company must comply with certain financial covenants, including a cash flow leverage ratio, an asset coverage ratio and a fixed charge coverage ratio. The credit agreement requires the Company to maintain a minimum profit threshold, limits the maximum capital lease expenditures and restricts the Company from declaring or paying dividends in cash or stock without prior bank approval. The Company is in compliance with all financial covenants for all periods presented.

5. TRADE ACCOUNTS RECEIVABLE PURCHASE PROGRAMS

Sale Programs

On June 25, 2014, the Company entered into an Account Purchase Agreement with Wells Fargo Bank, N.A. ("WFB") which provides that the Company may sell and assign to WFB and WFB may purchase from Company the accounts receivable of certain Company customers in a maximum aggregate amount outstanding of $50.0 million. The initial term of the agreement is 36 months with successive 12 month renewal terms. On December 18, 2014, the Company modified the original Account Purchase Agreement with WFB to allow the Company to account for the factored receivables as a true-sale. On July 16, 2015, the Company modified the Account Purchase Agreement with WFB to decrease the maximum aggregate amount of receivables available to factor from $50.0 million to $20.0 million. The decrease in the aggregate amount available was due to a change in customer mix and to reduce fees related to the program. The Company also has an Account Purchase Agreement with Orbian Financial Services (“Orbian”) which allows the Company to factor receivables from specific customers as a true-sale. This agreement may be canceled by either party at any time.

Total accounts receivables sold during the twelve months ended July 2, 2016 and June 27, 2015 was approximately $78.0 million and $12.1 million, respectively. Accounts receivables sold and not yet collected was approximately $1.7 million and $0.9 million as of July 2, 2016 and June 27, 2015, respectively. The receivables that were sold were removed from the condensed consolidated balance sheets and the cash received is reflected as cash provided by operating activities in the condensed consolidated statements of cash flows.

6. INCOME TAXES

Income tax provision consists of the following:

	Fiscal Year Ended		
	July 2, 2016	June 27, 2015	June 28, 2014
	(in thousands)		
Current income tax provision:			
United States	$1,014	$1,701	$1,220
Foreign	1,960	975	1,017
	2,974	2,676	2,237
Deferred income tax benefit:			
United States	(1,285)	(1,486)	1,566
Foreign	(71)	(194)	(2,193)
	(1,356)	(1,680)	(627)
Total income tax provision	$1,618	$996	$1,610

The Company has gross tax credit carryforwards of approximately $7.9 million at July 2, 2016. Included in total tax credits carryforwards is approximately $7.1 million in research and development (R&D) tax credits.

Management also has reviewed its other deferred tax assets for purposes of determining whether or not a valuation allowance may be required. A valuation allowance against these deferred tax assets is required if it is more likely than not that some of the deferred tax assets will not be realized. Based on the Company's increased profitability and estimated future repatriations from foreign subsidiaries, it has been determined that it is more likely than not that the deferred tax assets will be realized.

Management has reviewed and updated as necessary estimates of future repatriations of the undistributed earnings of its foreign subsidiaries. Based on this analysis, management expects to repatriate a portion of the foreign undistributed earnings based on increased sales growth driving additional U.S. capital requirements, cash requirements for potential acquisitions and to potentially implement certain tax strategies. No foreign earnings were repatriated from either foreign subsidiary during fiscal 2016 or 2015. The Company currently estimates that future repatriations from foreign subsidiaries will approximate $11.9 million. As such, as earnings are recognized in the United States, the Company would be subject to U.S. federal and state income taxes and potential withholding taxes are estimated to be approximately $5.9 million. Both the domestic tax and estimated withholding tax have been recorded as part of deferred taxes as of July 2, 2016. All other unremitted foreign earnings are expected to remain permanently reinvested for planned fixed asset purchases in foreign locations.

The Company has not provided for U.S. income taxes or foreign withholding taxes on approximately $13.5 million of earnings from foreign subsidiaries which are permanently reinvested outside the U.S. The unrecognized net tax provision, after netting U.S. federal and state income tax and any related foreign tax credits, would be approximately $2.1 million associated with these earnings.

In recent years, the Company's wholly owned foreign subsidiary in Mexico has been subject to a Mexican business flat tax called Impuesto Empresarial a Tasa Unica (IETU). However, effective January 1, 2014, IETU was repealed as part of a larger reform of the Mexican tax system and the impact of the repeal was recognized as a discrete tax benefit of $1.5 million during the second quarter of fiscal year 2014. The Company is now subject to the general Mexican tax regime (ISR). The effects of IETU and ISR have been included in the effective tax rate for the year ended June 28, 2014.

The Company's effective tax rate differs from the federal tax rate as follows:

	Fiscal Year Ended		
	July 2, 2016	June 27, 2015	June 28, 2014
	(in thousands)		
Federal income tax provision at statutory rates	$2,771	$1,802	$3,136
State income taxes, net of federal tax effect	250	133	—
Foreign tax rate differences	(442)	(80)	(439)
Effect of income tax credits	(1,254)	(1,085)	(202)
Effect of repatriation of foreign earnings, net	(161)	(80)	287
Other	454	124	330
Transaction costs	—	182	—
Effect of IETU repeal	—	—	(1,502)
Income tax provision	$1,618	$996	$1,610

The domestic and foreign components of income before income taxes were:

	Fiscal Year Ended		
	July 2, 2016	June 27, 2015	June 28, 2014
	(in thousands)		
Domestic	$2,228	$3,395	$4,687
Foreign	5,923	1,905	4,536
Income before income taxes	$8,151	$5,300	$9,223

Deferred income tax assets and liabilities consist of the following at:

	July 2, 2016	June 27, 2015
	(in thousands)	
Deferred tax assets:		
Tax credit carryforwards, net	$4,056	$2,843
Foreign subsidiaries - future tax credits	840	840
Inventory	508	559
Accruals	4,270	4,579
Mark-to-market adjustments	4,043	2,498
Other	86	138
Deferred income tax assets	$13,803	$11,457
Deferred tax liabilities:		
Foreign subsidiaries – unremitted earnings	(2,098)	(2,258)
Fixed assets	(1,025)	(941)
Identifiable intangibles	(1,613)	(1,866)
Other	(85)	(170)
Deferred income tax liabilities	$(4,821)	$(5,235)
Net deferred income tax assets	$8,982	$6,222
Balance sheet caption reported in:		
Long-term deferred income tax asset	$8,982	$6,723
Long-term deferred income tax liability	—	(501)
Net deferred income tax asset	$8,982	$6,222

As a result of retroactive application of ASU 2015-17 (Topic 740), Balance Sheet Classification of Deferred Taxes, we have reclassified our net current deferred tax assets and liabilities to net non-current deferred tax assets and liabilities in our Consolidated Balance Sheet as of July 2, 2016 and June 27, 2015.

Uncertain Tax Positions

The Company has R&D tax credits that approximate $7.1 million that have 20 year carryforwards before expiring. The Company's R&D tax credits expire in various fiscal years from 2021 to 2035. The Company also has alternative minimum tax credits, which do not expire, approximating $726,000.

As of July 2, 2016, the Company had unrecognized tax benefits of $3.8 million related to its gross R&D tax credits. The unrecognized tax benefits relate to certain R&D tax credits generated from 1999 to 2015.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

	Fiscal Year Ended		
	July 2, 2016	June 27, 2015	June 28, 2014
	(in thousands)		
Beginning Balance	$3,446	$3,072	$3,031
Additions based on tax positions related to the current year	314	374	41
Ending Balance	$3,760	$3,446	$3,072

The increase from the prior year is due to additional R&D credits that were recorded in 2016 as discussed above. Management does not anticipate any material changes to this amount during the next 12 months.

The Company recognizes interest accrued related to unrecognized tax benefits and penalties in its income tax provision. The Company has not recognized any interest or penalties in the fiscal years presented in these financial statements. The Company is subject to income tax in the U.S. federal jurisdiction, various state jurisdictions, Mexico and China. Certain years remain subject to examination but there are currently no ongoing exams in any taxing jurisdictions.

7. 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:

	Fiscal Year Ended		
	(in thousands, except per share information)		
	July 2, 2016	June 27, 2015	June 28, 2014
Net income	$ 6,533	$ 4,304	$ 7,613
Weighted average shares outstanding– basic	10,710	10,572	10,528
Effect of dilutive common stock awards	568	714	830
Weighted average shares outstanding – diluted	11,278	11,286	11,358
Earnings per share – basic	$ 0.61	$ 0.41	$ 0.72
Earnings per share – diluted	$ 0.58	$ 0.38	$ 0.67
Antidilutive SARs not included in diluted earnings per share	442	208	208

8. STOCK OPTION AND BENEFIT PLANS

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, research, development and engineering, 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.

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.
On July 29, 2015, the Company granted 248,166 SARs under the 2010 Incentive Plan to certain key employees and outside directors at a strike price of $10.26 and a grant date fair value of $3.65, as of July 2, 2016, 240,833 remain outstanding. The grant date fair value for the awards granted during fiscal year 2016 were estimated using the Black Scholes option valuation method with the following weighted average assumptions as of July 29, 2015:

	Fiscal Year 2016 July 29, 2015
Expected dividend yield	—%
Risk – free interest rate	1.39%
Expected volatility	43.66%
Expected life	4.00

On October 31, 2014, the Company granted 213,166 SARs under the 2010 Incentive Plan to certain key employees and outside directors at a strike price of $8.22 and a grant date fair value of $3.04, as of July 2, 2016, 205,833 remain outstanding. The grant date fair value for the awards granted during fiscal year 2016 were estimated using the Black Scholes option valuation method with the following weighted average assumptions as of October 31, 2014:

	Fiscal Year 2015 October 31, 2014
Expected dividend yield	—%
Risk – free interest rate	1.39%
Expected volatility	45.67%
Expected life	4.00

On July 31, 2013, the Company granted 213,166 SARs under the 2010 Incentive Plan to certain key employees and outside directors at a strike price of $11.34 and a grant date fair value of $4.67, as of July 2, 2016, 200,833 remain outstanding. The grant date fair value for the awards granted during fiscal year 2014 were estimated using the Black Scholes option valuation method with the following weighted average assumptions as July 31, 2013:

	Fiscal Year 2014 July 31, 2013
Expected dividend yield	—%
Risk – free interest rate	1.16%
Expected volatility	52.12%
Expected life	4.00

Subsequent to July 2, 2016, the Company granted 242,500 SARs with a strike price of $8.18 and a grant date fair value of $2.42.
Share-based compensation expense is recognized only for those awards that are expected to vest, with forfeitures estimated at the date of grant based on the Company’s historical experience and future expectations. This forfeiture rate will be revised, if necessary, in subsequent periods if actual forfeitures differ from the amount estimated. Share-based compensation expense for fiscal years ended July 2, 2016, June 27, 2015 and June 28, 2014 was $0.8 million, $0.7 million and $0.7 million, respectively.
The Black-Scholes option valuation model is used by the Company for estimating the fair value of SARs. Option valuation models require the input of highly subjective assumptions, particularly for the expected term and expected stock price volatility. Changes in these assumptions can materially affect the fair value estimates.
The intrinsic value for stock options and SARs exercised in fiscal years 2016, 2015 and 2014 was $0.2 million, $1.9 million and $0.4 million, respectively.
As of July 2, 2016, total unrecognized compensation expense related to nonvested share-based compensation arrangements was approximately $0.9 million. This expense is expected to be recognized over a weighted-average period of 1.79 years.

46

The following table summarizes the Company's SARs activity for all plans from June 27, 2015 through July 2, 2016:

	SARs Available For Grant	SARs Outstanding	Aggregate Intrinsic Value (in thousands)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)
Balances, June 27, 2015	855,836	813,831	$ 2,312	$ 7.99	2.5
Shares authorized	—				
SARs granted	(248,166)	248,166		10.26	
SARs forfeited	26,999	(26,999)		9.48	
SARs exercised	—	(63,333)	165	4.56	
Balances, July 2, 2016	634,669	971,665	$ 339	$ 8.75	2.4
Exercisable at July 2, 2016		324,166	$ 339	$ 6.37	0.7

Additional information regarding SARs outstanding and exercisable as of July 2, 2016, is as follows:

Range of Exercise Prices	Number Outstanding	Weighted Avg. Remaining Contractual Life (yrs.)	Weighted Avg. Exercise Price	Number Exercisable	Weighted Avg. Exercise Price
$4.40 – $6.40	129,333	0.0	$ 4.77	129,333	$ 4.77
6.41 – 8.41	400,666	1.1	7.84	194,833	7.44
8.42 – 10.42	240,833	3.7	10.26	—	—
10.43 – 11.34	200,833	2.1	11.34	—	—
$4.40 to $11.34	971,665	2.4	$ 8.75	324,166	$ 6.37

The Company has defined contribution plans available to U.S. employees who have attained age 21. Company contributions to the plans were approximately $0.6 million, $0.6 million, and $0.6 million during fiscal years 2016, 2015 and 2014, respectively.

9. COMMITMENTS AND CONTINGENCIES

Leases: As of July 2, 2016 and June 27, 2015, the Company did not have any property and equipment financed under capital leases. The Company had equipment financed through capital leases with a net book value of $1.7 million during fiscal year 2014. The related depreciation expense was $0.3 million for fiscal year 2014. As of July 2, 2016, the Company has operating leases for certain equipment and production facilities, which expire at various dates during the next six years.

Future minimum payments under non-cancelable operating leases at July 2, 2016, are summarized as follows (in thousands):

Fiscal Years Ending	Operating Leases
2017	$ 7,766
2018	3,831
2019	2,805
2020	1,261
2021	73
Thereafter	90
Total minimum lease payments	$ 18,385

Rental expense under operating leases was approximately $6.6 million, $3.8 million, and $1.8 million during fiscal years 2016, 2015 and 2014, respectively.
Warranty Costs: The Company provides warranties on certain product sales, and 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 establishes warranty reserves based on historical warranty costs for each product line combined with liability estimates based on the prior twelve months’ sales activities. As of July 2, 2016 and June 27, 2015, the reserve for warranty costs was approximately $30,000 and $115,000, respectively.

If actual return rates and/or repair and replacement costs differ significantly from estimates, adjustments to recognize additional cost of sales may be required in future periods. Warranty expense for fiscal years 2016, 2015 and 2014 was related to workmanship claims on keyboards and certain EMS products.

Litigation: The Company is party to certain lawsuits or claims in the ordinary course of business. The Company does not believe that these proceedings, individually or in the aggregate, will have a material adverse effect on the financial position, results of operations or cash flow of the Company.

Indemnification Rights: Under the Company's bylaws, the Company's directors and officers have certain rights to indemnification by the Company against certain liabilities that may arise by reason of their status or service as directors or officers. The Company maintains director and officer insurance, which may cover certain liabilities arising from its obligation to indemnify its directors and officers and former directors in certain circumstances.

10. 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. There have been no changes in the fair value methodologies used at July 2, 2016 and June 27, 2015.

The following table summarizes the fair value of assets (liabilities) of the Company's derivatives that are required to be measured on a recurring basis as of July 2, 2016 and June 27, 2015 (in thousands):

	July 2, 2016			
	Level 1	Level 2	Level 3	Total Fair Value
Financial Assets:				
Foreign currency forward contracts	$—	$136	$ —	$136
Financial Liabilities:				
Interest rate swaps	$—	$(498)	$ —	$(498)
Foreign currency forward contracts	$—	$(11,112)	$ —	$(11,112)

	June 27, 2015			
	Level 1	Level 2	Level 3	Total Fair Value
Financial Assets:				
Interest rate swaps	$—	$25	$ —	$25
Financial Liabilities:				
Interest rate swaps	$—	$(443)	$ —	$(443)
Foreign currency forward contracts	$—	$(6,799)	$ —	$(6,799)

The Company currently has forward contracts to hedge known future cash outflows for expenses denominated in the Mexican peso and an interest rate swap to mitigate risk associated with certain borrowings under the Company's debt arrangement. 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 (loss), 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 July 2, 2016 and June 27, 2015 reasonably approximate their fair value. The Company's long-term debt primarily consists of a revolving line of credit and a term loan. Borrowings under the revolving line of credit bear interest at either a "Base Rate" or a "Fixed Rate," as elected by the Company. Each of these rates is a variable floating rate dependent upon current market conditions and the Company's current credit risk as discussed in footnote 4.

As a result of the determinable market rate for our revolving credit and term debt it is classified within Level 2 of the fair value hierarchy. As of July 2, 2016, the discounted cash flows of the revolving line of credit and the term loan were estimated to be $18.1 million and $26.3 million, respectively, with carrying values that reasonably approximate their fair values. As of June 27, 2015, the discounted cash flows of the revolving line of credit and the term loan were estimated to be $11.6 million and $31.3 million, respectively, with carrying values that reasonably approximate their fair values.

11. DERIVATIVE FINANCIAL INSTRUMENTS

As of July 2, 2016, the Company had outstanding foreign currency forward contracts of $69.4 million. These contract maturity dates extend through June 2019. As of July 2, 2016, the net amount of unrealized loss expected to be reclassified into earnings within the next 12 months is approximately $3.3 million. During the fiscal year ended July 2, 2016, the Company entered into $25.9 million of foreign currency forward contracts and settled $21.5 million of such contracts. During the fiscal year ended June 27, 2015, the Company entered into $23.1 million of foreign currency forward contracts and settled $20.5 million of such contracts. During the fiscal year ended June 28, 2014, the Company entered into $15.2 million of foreign currency forward contracts and settled $22.5 million of such contracts.

On October 1, 2014, the Company entered into an interest rate swap contract with an effective date of September 1, 2015 and a termination date of September 3, 2019, with a notional amount of $25.0 million related to the borrowings outstanding under the term loan and line of credit. As of July 2, 2016 and June 27, 2015, the remaining notional balance of this swap was $20.5 million and $25.0 million, respectively. This interest rate swap pays the Company variable interest at the one month LIBOR rate, and the Company pays the counter party a fixed interest rate. The fixed interest rate for the contract is 1.97% that replaces the one month LIBOR rate component of our contractual interest to be paid to WFB as part of our debt facilities. Based on the terms of the interest rate swap contract and the underlying borrowings outstanding under the term loan, the interest rate contract was determined to be effective, and thus qualifies as a cash flow hedge.

The following table summarizes the fair value of derivative instruments in the Consolidated Balance Sheets as of July 2, 2016 and June 27, 2015 (in thousands):

Derivatives Designated as Hedging Instruments	Balance Sheet Location	July 2, 2016 Fair Value	June 27, 2015 Fair Value
Foreign currency forward contracts	Other long-term assets	$136	$—
Foreign currency forward contracts	Other current liabilities	$(4,670)	$(2,517)
Foreign currency forward contracts	Other long-term liabilities	$(6,442)	$(4,282)
Interest rate swaps	Other long-term assets	$—	$25
Interest rate swaps	Other current liabilities	$(264)	$(271)
Interest rate swaps	Other long-term liabilities	$(234)	$(172)

The following table summarizes the gain (loss) on derivative instruments, net of tax, on the Consolidated Statements of Income for the fiscal year 2016 (in thousands):

Derivatives Designated as Hedging Instruments	Classification of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	AOCI Balance as of June 27, 2015	Effective Portion Recorded In AOCI	Effective Portion Reclassified From AOCI Into Income	AOCI Balance as of July 2, 2016
Forward contracts	Cost of sales	$ (4,487)	$ (6,939)	$ 4,181	$ (7,245)
Interest rate swap	Interest expense	(276)	(348)	296	(328)
Total		$ (4,763)	$ (7,287)	$ 4,477	$ (7,573)

The following table summarizes the gain (loss) on derivative instruments, net of tax, on the Consolidated Statements of Income for the fiscal year 2015 (in thousands):

Derivatives Designated as Hedging Instruments	Classification of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	AOCI Balance as of June 28, 2014	Effective Portion Recorded In AOCI	Effective Portion Reclassified From AOCI Into Income	AOCI Balance as of June 27, 2015
Forward contracts	Cost of sales	$ 2,403	$ (7,208)	$ 318	$ (4,487)
Interest rate swap	Interest expense	—	(276)	—	(276)
Total		$ 2,403	$ (7,484)	$ 318	$ (4,763)

The following table summarizes the gain (loss) on derivative instruments, net of tax, on the Consolidated Statements of Income for the fiscal year 2014 (in thousands):

Derivatives Designated as Hedging Instruments	Classification of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	AOCI Balance as of June 29, 2013	Effective Portion Recorded In AOCI	Effective Portion Reclassified From AOCI Into Income	AOCI Balance as of June 28, 2014
Forward contracts	Cost of sales	$ 1,313	$ 1,915	$ (825)	$ 2,403

49

As of July 2, 2016, the Company does not have any foreign exchange contracts with credit-risk-related contingent features. The Company is subject to the risk of fluctuating interest rates from our line of credit and foreign currency risk resulting from our China operations. The Company does not currently manage these risk exposures by using derivative instruments.

12. ENTERPRISE-WIDE DISCLOSURES

Operating segments are defined in ASC Topic 280, Segment Reporting as components of an enterprise for which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. The Company's chief operating decision maker is its Chief Executive Officer. As of July 2, 2016, the Company operates and internally manages a single operating segment, Electronics Manufacturing Services as this is the only discrete financial information that is regularly reviewed by the chief operating decision maker. This segment provides integrated electronic and mechanical engineering, assembly, sourcing and procurement, logistics, and new product testing for our customers.

Products and Services

Of the revenues for the years ended July 2, 2016, June 27, 2015, and June 28, 2014, EMS sales and services were $483.3 million, $432.1 million and $303.1 million, respectively. Keyboard sales for the years ended July 2, 2016, June 27, 2015, and June 28, 2014 were $1.7 million, $1.9 million and $2.3 million, respectively.

Geographic Areas

Net sales and long-lived assets (property, plant, and equipment) by geographic area for the years ended and as of July 2, 2016, June 27, 2015 and June 28, 2014 are summarized in the following table. Net sales set forth below are based on the shipping destination. Long-lived assets information is based on the physical location of the asset.

	Fiscal Year Ended (in thousands)		
	2016	2015	2014
Geographic net sales:			
Domestic (U.S.)	$347,552	$301,891	$197,700
Foreign	137,413	132,106	107,694
Total	$484,965	$433,997	$305,394
Long-lived assets:			
United States	$11,406	$8,969	$2,888
Mexico	15,756	17,156	19,577
China	763	849	1,131
Total	$27,925	$26,974	$23,596

Percentage of net sales made to customers located in the following countries:

	Fiscal Year Ended		
	2016	2015	2014
United States	72%	70%	65%
Canada	7	10	16
Other foreign countries [a]	21	20	19
Total	100%	100%	100%

(a) No other individual foreign country accounted for 10% or more of the foreign sales in fiscal years 2016, 2015 or 2014.

Significant Customers

The percentage of net sales to and trade accounts receivables from significant customers were as follows:

	Percentage of Net Sales Fiscal Year			Percentage of Trade Accounts Receivable Fiscal Year	
	2016	2015	2014	2016	2015
Customer A	18%	17%	20%	24%	18%
Customer B	*	*	15%	*	*
Customer C	*	*	15%	*	*

* Current customer amount represents less than 10%.

13. QUARTERLY FINANCIAL DATA (Unaudited)

	Fiscal Year Ended July 2, 2016			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(in thousands, except per share amounts)			
Net sales	$126,209	$116,403	$118,448	$123,905
Gross profit	8,919	9,110	9,955	10,841
Income before income taxes	1,247	1,882	2,137	2,885
Net income	817	1,787	1,783	2,146
Earnings per common share-basic	$0.08	$0.17	$0.17	$0.20
Earnings per common share-diluted	$0.07	$0.16	$0.16	$0.20
Weighted average shares outstanding				
Basic	10,706	10,710	10,711	10,714
Diluted	11,391	11,418	11,068	10,966

	Fiscal Year Ended June 27, 2015			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(in thousands, except per share amounts)			
Net sales	$86,342	$114,311	$112,915	$120,429
Gross profit	4,238	9,239	9,436	10,392
(Loss) income before income taxes	(1,894)	2,113	2,234	2,847
Net (loss) income	(1,523)	1,626	1,861	2,340
(Loss) earnings per common share-basic	$(0.14)	$0.15	$0.18	$0.22
(Loss) earnings per common share-diluted	$(0.14)	$0.14	$0.16	$0.21
Weighted average shares outstanding				
Basic	10,548	10,552	10,552	10,636
Diluted	10,548	11,471	11,556	11,414

14. ACQUISITIONS

On July 1, 2013, the Company acquired substantially all of the assets of Sabre Assembly & Manufacturing Co. of Texas (“Sabre”), a sheet metal fabrication company with facilities located in Juarez, Mexico. The acquisition of Sabre enables the Company to offer metal fabrication directly to its customers, in combination with plastic molding, PCB assembly, complete product assembly, design engineering and testing engineering services. Under the terms of the transaction, the assets acquired included manufacturing equipment, inventory, customer relationships and non-compete agreements with key employees. No debt or liabilities were assumed. The total cash payment of $6.0 million was funded through existing cash. The Company incurred approximately $50,000 of costs related to due diligence and closing this acquisition.

The following table summarizes the fair values of the assets acquired as of the date of acquisition (in thousands):

	Fair Values At July 1, 2013
Current Assets	$ 777
Fixed Assets	1,168
Non-Compete Agreements	372
Customer Relationships	1,970
Goodwill	1,740
Fair value of assets acquired	$ 6,027

The Sabre acquisition was accounted for using the acquisition method of accounting whereby the total purchase price is allocated to tangible and intangible assets and liabilities based on their fair values on the date of acquisition. The Company determined the purchase price allocations on the acquisition based on estimates of the fair values of the assets acquired.

On September 3, 2014, the Company acquired all of the outstanding stock of Ayrshire, resulting in Ayrshire becoming a wholly owned subsidiary of the Company. Ayrshire provides printed circuit board assembly and other electronic manufacturing services to a diversified customer base through manufacturing facilities operated by Ayrshire or its subsidiaries in Minnesota, Arkansas, Mississippi, and Kentucky and through a sheltered maquiladora facility in Reynosa, Mexico. The Reynosa, Mexico operations were moved to the Company's existing facility in Juarez, Mexico. This acquisition expands our printed circuit board assembly capacity, total revenue, and adds to and diversifies our customer base with the addition of many new multi-national companies. The total cash payment of approximately $48.0 million was funded through borrowings on our term loan, revolving line of credit, and cash on hand. The Company incurred approximately $775,000 of costs related to due diligence.

During the fourth quarter of 2016, management approved a plan for the closure of the Harrodsburg, Kentucky facility in order to reduce costs and further improve operating efficiencies. Customer programs from this location will be transferred to other manufacturing facilities primarily in the United States. The Company expects to incur approximately $250,000 in costs related to the closure of this facility as well as transferring customer programs to other locations. The Harrodsburg, Kentucky facility is expected to be shut down by the end of the first quarter of fiscal year 2017.

The following table summarizes the purchase price paid for Ayrshire and the fair value of the assets acquired and liabilities assumed as of the date of acquisition (in thousands):

	Estimated Fair Values At September 3, 2014
Purchase Price Paid	$ 48,010
Cash Acquired	(46)
Purchase Price, Net of Cash Received	$ 47,964
Cash	$ 46
Accounts Receivable	21,211
Inventories	21,772
Other Current Assets	1,013
Property, Plant and Equipment	7,823
Favorable Leases	2,941
Customer Relationships	2,833
Non-Compete Agreements	196
Goodwill	8,217
Other Assets	42
Accounts Payable	(11,070)
Accrued Salaries and Wages	(2,188)
Other Current Liabilities	(2,408)
Deferred Tax Liability	(2,418)
Fair Value of Assets Acquired	$ 48,010

The Ayrshire acquisition was accounted for using the acquisition method of accounting whereby the total purchase price is allocated to tangible and intangible assets and liabilities based on their fair values on the date of acquisition. The Company determined the purchase price allocations on the acquisition based on estimates of the fair values of the assets acquired and liabilities assumed.

The following summary pro forma condensed consolidated financial information reflects the Ayrshire acquisition as if it had occurred on June 30, 2013 for purposes of the statements of income. This summary pro forma information is not necessarily representative of what the Company’s results of operations would have been had this acquisition in fact occurred on June 30, 2013 and is not intended to project the Company’s results of operations for any future period.

Pro forma condensed consolidated financial information for the years ended June 27, 2015 and June 28, 2014 (in thousands):

	Fiscal Year Ended (unaudited)	
	June 27, 2015	June 28, 2014
Net sales	$457,475	$431,274
Net income	$4,136	$9,476

It is impracticable to determine the revenue and net income related to the Ayrshire acquisition as certain customer programs have been transferred to the Company's Juarez facilities.

15. GOODWILL AND OTHER INTANGIBLE ASSETS

The Company recorded goodwill in connection with the Ayrshire and Sabre acquisitions resulting primarily from the synergies that resulted from the Company’s acquisitions and the assembled workforce. The goodwill is not amortized for financial accounting purposes. The goodwill from the acquisitions is not deductible for tax purposes. As of July 2, 2016 and June 27, 2015, goodwill was recorded at $10.0 million.

53

The changes in the carrying value of goodwill are as follows (in thousands):

	July 2, 2016	June 27, 2015
Goodwill, beginning of period	$9,957	$1,740
Additions to goodwill during the period	—	8,217
Goodwill, end of period	$9,957	$9,957

The components of acquired intangible assets are as follows (in thousands):

	July 2, 2016			
	Amortization Period in Years	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Other intangible assets:				
Non-Compete Agreements	3 - 5	$ 568	$ (343)	$ 225
Customer Relationships	10	4,803	(1,110)	3,693
Favorable Lease Agreements	4 - 7	2,941	(931)	2,010
Total		$ 8,312	$ (2,384)	$ 5,928

	June 27, 2015			
	Amortization Period in Years	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Other intangible assets:				
Non-Compete Agreements	3 - 5	$ 568	$ (204)	$ 364
Customer Relationships	10	4,803	(630)	4,173
Favorable Lease Agreements	4 - 7	2,941	(423)	2,518
Total		$ 8,312	$ (1,257)	$ 7,055

Amortization expense related to intangible assets was approximately $1.1 million and $1.0 million for the years ended July 2, 2016 and June 27, 2015, respectively.

Aggregate amortization expense related to existing intangible assets by fiscal year is currently estimated to be as follows (in thousands):

Fiscal Years Ending	Amount
2017	$ 1,128
2018	1,073
2019	818
2020	783
2021	784
Thereafter	1,342
Total amortization expense	$ 5,928

Item 9: CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURES

None

Item 9A: 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 July 2, 2016, the Company’s disclosure controls and procedures are effective based on that criteria.

Management’s Report on Internal Control over Financial Reporting

Our management has the responsibility to establish and maintain adequate internal controls over our financial reporting, as defined in Rule 13a-15(f) under the Securities and Exchange Act of 1934. Our internal controls are designed to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of our external financial statements in accordance with generally accepted accounting principles (GAAP).

Due to inherent limitations of any internal control system, management acknowledges that there are limitations as to the effectiveness of internal controls over financial reporting and therefore recognize that only reasonable assurance can be gained from any internal control system. Accordingly, our internal control system may not detect or prevent material misstatements in our financial statements and projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Under the supervision and participation of management, including the Chief Executive Officer and Chief Financial Officer, we have performed an assessment of the effectiveness of our internal controls over financial reporting as of July 2, 2016. This assessment was based on the criteria established in Internal Control-Integrated Framework (2013), issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our assessment, we believe that as of July 2, 2016, the Company’s internal control over financial reporting is effective based on that criteria.

The effectiveness of the Company's internal control over financial reporting as of July 2, 2016 has been audited by BDO USA LLP, an independent registered public accounting firm, as stated in their report which is included herein.

Changes in Internal Control over Financial Reporting

There have been no significant changes in our internal controls over financial reporting during our fourth fiscal quarter ended July 2, 2016 that have materially affected, or are reasonable 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)).

Report of Independent Registered Public Accounting Firm
Board of Directors and Stockholders
Key Tronic Corporation
Spokane Valley, Washington

We have audited Key Tronic Corporation's internal control over financial reporting as of July 2, 2016, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Key Tronic Corporation's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Item 9A “Management's Report on Internal Control over Financial Reporting”. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Key Tronic Corporation maintained, in all material respects, effective internal control over financial reporting as of July 2, 2016, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Key Tronic Corporation as of July 2, 2016 and June 27, 2015, and the related consolidated statements of income, comprehensive income (loss), shareholders' equity, and cash flows for each of the three years in the period ended July 2, 2016 and our report dated September 9, 2016, expressed an unqualified opinion thereon.

/s/ BDO USA, LLP
Spokane, Washington
September 9, 2016

Item 9B: OTHER INFORMATION

None

PART III

Item 10: DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Directors of the Registrant

Information on the nominees for election as Directors of the Company is incorporated by reference from the Company's definitive proxy statement for the 2016 Annual Meeting of Shareholders to be filed pursuant to Regulation 14A under the Exchange Act no later than 120 days after the end of the Company's 2016 fiscal year.

Executive Officers of the Registrant

This information is included in a separate item captioned "Executive Officers of the Registrant" in Item 1 of Part 1 of this report pursuant to Instruction G(3) of Form 10-K and Instruction 3 to Item 401(b) of Regulation S-K.

Compliance with Section 16(a) of the Exchange Act:

Incorporated by reference to Key Tronic Corporation's 2016 Proxy Statement to Shareholders.

Code of Conduct

The Board of Directors has adopted a written Code of Conduct which applies to its directors and employees, including its executive officers. The Code of Conduct is available on the Company's website at www.keytronic.com. The Company intends to disclose on its website any amendments to or waivers of the Code of Conduct.

Item 11: EXECUTIVE COMPENSATION

Information appearing under the caption "Executive Compensation" in the Company's 2016 Proxy Statement is incorporated herein by this reference.

Item 12: SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The following table sets forth the aggregate information for the Company's equity compensation plans in effect as of July 2, 2016.

EQUITY COMPENSATION PLAN INFORMATION

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants, and rights (a)	Weighted-average exercise price of outstanding options, warrants, and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a) (c)
Equity compensation plans approved by security holders(1)	971,665	$ 8.75	634,669
Equity compensation plans not approved by security holders	—	$ —	—
Total	971,665	$ 8.75	634,669

(1) Included are the 1,200,000 shares subject to the 2010 Plan, the issuance of which were approved by the shareholders at the 2010 Annual Meeting. During the 2015 Annual Meeting, an additional 1,000,000 shares were approved. As a result of the shareholder approval, the Company made the decision to amend the cash-settled SARs granted during fiscal year 2010 to stock-settled SARs effective October 21, 2011.

Information under the caption "Beneficial Ownership of Securities" in the Company's 2016 Proxy Statement is incorporated herein by this reference.

Item 13: CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

Information appearing under the caption “Related Person Transactions”, “Compensation Committee Interlocks and Insider Participation”, and “Directors’ Independence” in the Company’s 2016 Proxy Statement is incorporated herein by this reference.

Item 14: PRINCIPAL ACCOUNTING FEES AND SERVICES

Information appearing under the caption “Principal Accountant Fees and Services” in the Company’s 2016 Proxy Statement is incorporated herein by this reference.

PART IV

Item 15: EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) 1. FINANCIAL STATEMENTS

Other schedules are omitted because of the absence of conditions under which they are required, or because required information is given in the financial statements or notes thereto.

3. EXHIBITS

Exhibit No.	Description
3.1	Articles of Incorporation, incorporated by reference to the Exhibits to the Company's form 10-K for the year ended June 30, 1986
3.2	Bylaws, as amended, incorporated by reference to the Exhibits to the Company's Form 10-K for the year ended June 30, 1986
10.1*	Executive Stock Option Plan, incorporated by reference to Exhibits to the Company's Form 10-K for the year ended June 30, 1986
10.2*	Amended and Restated 1990 Stock Option Plan for Non-Employee Directors, as amended, incorporated by reference to the Company's 1997 Proxy Statement (dated October 10, 1997), pages 14-17
10.3*	1995 Executive Stock Option Plan, incorporated by reference to the Company's 1995 Proxy Statement, pages 19-22
10.4*	2000 Employee Stock Option Plan, incorporated by reference to the Exhibits to the Company's Form 10-Q for the quarter ended January 1, 2000
10.5*	Officers' Employment Contracts, incorporated by reference to the Company's 1998 Proxy Statement, pages 10 and 11
10.6*	Addenda to Officers' Employment Contracts, incorporated by reference to Exhibits to the Company's Form 10-Q for the quarter ended January 1, 2000
10.7*	Description of Retention Bonus Plan, incorporated by reference to the Exhibits to the Company's 10-Q for the quarter ended December 28, 2002
10.8*	Addenda to Officers' Employment Contracts, incorporated by reference to Exhibits to the Company's Form 10-K for the year ended June 29, 2002
10.9	Promise to execute a Purchase and Sale Agreement with Key Safety Systems de Mexico, S.A. de C.V., incorporated by reference to the Exhibit to the Company's Form 8-K filed April 26, 2005
10.10	Summary of material terms and conditions of the Purchase and Sale Agreement with Key Safety Systems de Mexico, S.A. de C.V., incorporated by reference to the Exhibit to the Company's Form 8-K filed June 6, 2005
10.11*	Summary of Key Tronic Corporation Incentive Compensation Plan, incorporated by reference to Exhibit 10.23 to the Company's Form 10-K for the year ended July 2, 2005

10.12*	Summary of Incentive Compensation Plan Performance goals and Target Payments for fiscal year 2007, incorporated by reference to the Company's Form 8-K filed July 28, 2006
10.13*	Summary of Fiscal Years 2007 – 2009 Long Term Incentive Plan Performance Measures and Awards, incorporated by reference to the Company's Form 8-K filed July 28, 2006
10.14*	Summary of Key Tronic Corporation Long Term Incentive Compensation Plan, incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed September 27, 2005
10.15	Summary of material terms and conditions of the Purchase and Sale Agreement with Todenko Mexico S.A. de C.V., incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed October 12, 2006
10.16	Summary of material terms and conditions of the Purchase and Sale Agreement with Todenko Mexico S.A. de C.V., incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed November 20, 2006
10.17	Summary of material terms and conditions of the Sale and Purchase Agreement with Adevco Corporation, incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed January 5, 2007
10.18	Summary of Second Amendment to Agreement of Sale and Purchase Agreement with Adevco Corporation, incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed April 11, 2007
10.19*	Summary of Incentive Compensation Plan Performance Goals and Target Payments for Fiscal Year 2008 and Fiscal Years 2008-2010 Long Term Incentive Plan Performance Measures and Awards incorporated by reference to the Company's Form 8-K filed July 27, 2007
10.20*	Summary of Incentive Compensation Plan Performance Goals and Target payments for Fiscal Year 2009 and Fiscal Years 2009 – 2011 Long Term Incentive Plan Performance Measures and Awards incorporated by reference to the Company's Form 8-K filed July 24, 2008
10.21*	Summary of Incentive Compensation Plan Performance Goals and Target payments for Fiscal Year 2010 and Fiscal Years 2010 – 2012 Long Term Incentive Plan Performance Measures and Awards incorporated by reference to the Company's Form 8-K filed July 23, 2009
10.22	Financing Agreement with Wells Fargo Bank, N.A., incorporated by reference to the Exhibits to the Company's Form 8-K filed on August 24, 2009
10.23*	2010 Incentive Plan, incorporated by reference to Exhibit 10.36 to the Company's Form 10-K for the year ended July 3, 2010
10.24*	Employment Contract with Douglas G. Burkhardt, incorporated by reference to Exhibit 10.37 to the Company's Form 10-K for the year ended July 3, 2010
10.25	Summary of material terms and conditions of the Purchase and Sale Agreement with Autopartes Y Arneses de Mexico S.A. de C.V., incorporated by reference to Exhibit 10.38 to the Company's Form 10-K for the year ended July 3, 2010
10.26*	Summary of Incentive Compensation Plan Performance Goals and Target Payments for Fiscal Year 2011 and Fiscal Years 2011 – 2013 Long Term Incentive Plan Performance Measures and Awards incorporated by reference to the Company's Form 8-K filed July 27, 2011

60

10.27*	Amendment to Employment Contract of Craig D. Gates, dated August 23, 2011; of Ronald F. Klawitter, dated August 23, 2011 and of Douglas G. Burkhardt dated September 6, 2011; incorporated by reference to the Exhibits to the Company's Form 10-K for the year ended July 2, 2011
10.28	Second Loan Modification Agreement to the Credit Agreement with Wells Fargo Bank, N.A., incorporated by reference to the Exhibits to the Company's Form 8-K filed on January 30, 2012
10.29*	Amendment to Employment Contract of Craig D. Gates, dated May 10, 2012, and of Douglas G. Burkhardt dated May 10, 2012; incorporated by reference to the Exhibits to the Company's Form 10-Q filed on May 14, 2012
10.30*	Summary of Incentive Compensation Plan Performance Goals and Target Payments for Fiscal Year 2013 and Fiscal Years 2013 – 2015 Long Term Incentive Plan Performance Measures and Awards incorporated by reference to the Company's Form 8-K filed August 7, 2012
10.31*	Summary of Incentive Compensation Plan Performance Goals and Target Payments for Fiscal Year 2014 and Fiscal Years 2014 – 2016 Long Term Incentive Plan Performance Measures and Awards incorporated by reference to the Company's Form 8-K filed August 6, 2013
10.32*	Summary of Incentive Compensation Plan Performance Goals and Target Payments for Fiscal Year 2015 and Fiscal Years 2015 – 2017 Long Term Incentive Plan Performance Measures and Awards incorporated by reference to the Company's Form 8-K filed August 1, 2014
10.33	Summary of material terms and conditions of the Stock Purchase Agreement with CDR Manufacturing and Amended and Restated Credit Agreement with Wells Fargo Bank, N. A. incorporated by reference to the Company's Form 8-K filed September 9, 2014
10.34*	Summary of Incentive Compensation Plan Performance Goals and Target Payments for Fiscal Year 2016 and Fiscal Years 2016 – 2018 Long Term Incentive Plan Performance Measures and Awards incorporated by reference to the Company's Form 8-K filed July 30, 2015
10.35	First Amendment to Amended and Restated Credit Agreement and Second Replacement Revolving Line of Credit Note with Wells Fargo Bank, National Association, incorporated by reference to the Company's Form 8-K filed August 11, 2015
10.36*	Summary of Incentive Compensation Plan Performance Goals and Target Payments for Fiscal Year 2017 and Fiscal Years 2017 – 2019 Long Term Incentive Plan Performance Measures and Awards incorporated by reference to the Company's Form 8-K filed July 29, 2016
21.	Subsidiaries of Registrant, submitted herewith
23.1	Consent of Independent Registered Public Accounting Firm, submitted herewith
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer, submitted herewith
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer, submitted herewith
32.1	Section 1350 Certification of Chief Executive Officer, submitted herewith
32.2	Section 1350 Certification of Chief Financial Officer, submitted herewith

101.INS XBRL Instance Document **

101.SCH XBRL Taxonomy Extension Schema Document **

101.CAL XBRL Taxonomy Extension Calculation Linkbase Document **

101.DEF XBRL Taxonomy Extension Definition Linkbase Document **

101.LAB XBRL Taxonomy Extension Label Linkbase Document **

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document **

* Management contract or compensatory plan or arrangement

** Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, or Section 18 of the Securities and Exchange Act of 1934, as amended and otherwise are not subject to liability under those sections.

SCHEDULE II
KEY TRONIC CORPORATION AND SUBSIDIARIES
CONSOLIDATED VALUATION AND QUALIFYING ACCOUNTS
FISCAL YEARS ENDED JULY 2, 2016, JUNE 27, 2015, AND JUNE 28, 2014

	Fiscal Year Ended		
	2016	2015	2014
	(in thousands)		
Allowance for Obsolete Inventory			
Balance at beginning of year	$417	$332	$381
Provisions	757	520	257
Dispositions	(61)	(435)	(306)
Balance at end of year	$1,113	$417	$332
Allowance for Doubtful Accounts			
Balance at beginning of year	$97	$—	$40
Provisions	38	97	37
Write-offs	—	—	(77)
Balance at end of year	$135	$97	$—

62

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: September 9, 2016

KEY TRONIC CORPORATION

By: /s/ Craig D. Gates
Craig D. Gates, President and Chief Executive Officer
(Principal Executive Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated:

/s/ Craig D. Gates Craig D. Gates Director and President and Chief Executive Officer (Principal Executive Officer)	September 9, 2016 Date
/s/ Brett R. Larsen Brett R. Larsen Executive Vice President of Administration, Chief Financial Officer and Treasurer (Principal Financial Officer)	September 9, 2016 Date
/s/ Ronald F. Klawitter Ronald F. Klawitter, Director	September 9, 2016 Date
/s/ James R. Bean James R. Bean, Director	September 9, 2016 Date
/s/ Yacov A. Shamash Yacov A. Shamash, Director	September 9, 2016 Date
/s/ Patrick Sweeney Patrick Sweeney, Director and Chairman of the Board	September 9, 2016 Date