KEY TRONIC CORP
Form 10-K
September 05, 2014

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 JUNE 28, 2014
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 28, 2013, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was $110.6 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: 10,551,680 shares of common stock were outstanding as of September 3, 2014.

Documents Incorporated by Reference:

The following documents are incorporated by reference to the extent specified herein:

Document Description	Part of Form 10-K
Proxy Statement dated September 19, 2014	Part III

KEY TRONIC CORPORATION
2014 FORM 10-K
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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 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.

Our Industry and Strategy

The expansion of the EMS industry has allowed us to continue to expand our customer base and the industries that we serve. The challenging global macroeconomic environment had a negative impact on previously held customer programs during the past fiscal year, as we saw a significant decrease in revenue generated from two of our largest customer programs. However, we are successfully confronting the challenging global macroeconomic environment by controlling our costs and winning new customer programs, which allowed us to maintain our profitability and a strong balance sheet. 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, 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, 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.

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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 the following: Continuing to win programs from new and existing customers, balancing 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 during a time of macroeconomic uncertainty.

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 2014, 2013 and 2012, the five largest customers in each year accounted for 62%, 71% and 73% of combined total net sales, respectively. At the end of fiscal year 2014, we were generating revenue from 196 separate programs and 59 distinct customers as compared to 183 programs and 56 customers at the end of fiscal year 2013. As these new customers' sales ramp up and new programs are won our concentration of revenue should continue to decrease in the future.

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		
	2014	2013	2012
Customer A	20%	19%	16%
Customer B	15%	23%	29%
Customer C	15%	21%	17%

Although keyboard manufacturing is still included in our product offerings, we do not expect annual keyboard sales to be a material component of our business. We realized revenues of approximately $2.3 million, $2.4 million and $2.8 million in fiscal years 2014, 2013 and 2012, respectively, from the sale of keyboards. In order to accommodate the demand for standard keyboard layouts, we maintain a purchase-from-stock program. The more popular standard layouts are built and stocked for immediate availability.

We market our products and services primarily through our direct sales department aided by strategically located field sales people and distributors. Although we maintain relationships with several independent sales organizations to assist in marketing our EMS product lines, commissions earned and paid are not material to the consolidated financial statements.

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 manufacture the majority of plastic 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 and Patents

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. We also own several keyboard patents; however, since our focus is EMS, management believes that these patents will not have a significant impact on future revenues.

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. We maintain a 401(k) plan for U.S. employees, which provides a discretionary matching company contribution of up to 4% of an employee’s salary. We provide group health, life, and disability insurance plans. We also maintain stock option plans and other long term incentive plans for certain employees and outside directors.

As of June 28, 2014 we had 3,343 employees compared to 2,584 on June 29, 2013, and 2,700 on June 30, 2012. 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.

Backlog

On July 26, 2014 our order backlog was valued at approximately $103.1 million, compared to approximately $60.0 million on July 27, 2013. Even though our order backlog is comprised of firm purchase orders, 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	55	President and Chief Executive Officer
Ronald F. Klawitter	62	Executive Vice President of Administration, Chief Financial Officer and Treasurer
Douglas G. Burkhardt	56	Executive Vice President of Worldwide Operations
Philip S. Hochberg	52	Executive Vice President of Business Development
Lawrence J. Bostwick	62	Vice President of Engineering and Quality
Brett R. Larsen	41	Vice President of Finance and Controller
Frank Crispigna III	53	Vice President of Materials
Duane D. Mackleit	46	Vice President of Program Management

Executive Officers

CRAIG D. GATES – President and Chief Executive Officer

Mr. Gates, age 55, 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.

RONALD F. KLAWITTER – Executive Vice President of Administration, Chief Financial Officer, and Treasurer

Mr. Klawitter, age 62, has been Executive Vice President of Administration, CFO, and Treasurer since July 1997. Previously he was Vice President of Finance, Secretary, and Treasurer of the Company from October 1995 to July 1997. He was Acting Secretary from November 1994 to October 1995 and Vice President of Finance and Treasurer from 1992 to October 1995. From 1987 to 1992, Mr. Klawitter was Vice President of Finance at Baker Hughes Tubular Service, a subsidiary of Baker Hughes, Inc. Mr. Klawitter has a BA degree from Wittenberg University and is a Certified Public Accountant.

DOUGLAS G. BURKHARDT – Executive Vice President of Worldwide Operations

Mr. Burkhardt, age 56, 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 52, has been Executive Vice President of Business Development since July 2012. Prior 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 Psychology, with a minor in Business from Washington University in St. Louis.

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LAWRENCE J. BOSTWICK – Vice President of Engineering and Quality
Mr. Bostwick, age 62, 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.
BRETT R. LARSEN – Vice President of Finance, and Controller
Mr. Larsen, age 41, has served as Vice President of Finance and Controller since February 2010. 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 Seidman, 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.
FRANK CRISPIGNA III – Vice President of Materials
Mr. Crispigna, age 53, 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 46, 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 N. 4424 Sullivan Road, Spokane Valley, Washington 99216, and our telephone number is (509) 928-8000. Our website is located at http://www.keytronicems.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.
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. 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, and the impact of hedging activities.
We are exposed to general economic conditions, which could have a material adverse impact on our business, operating results and financial condition.
Recently there have been adverse conditions and uncertainty in the global economy as the result of unstable global financial and credit markets, inflation, and recession. These unfavorable economic conditions and the weakness of the credit market could affect the demand for our customers' products. The current global macroeconomic environment may affect some of our customers that could reduce orders and change forecasts which could adversely affect our sales in future periods. Additionally, the financial strength of our customers and suppliers and their ability to obtain and rely on credit financing may affect their ability to fulfill their obligations to us and have an adverse 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. Specifically, some of our major customers provide products to the banking and gambling industries which have been adversely affected by the unfavorable economic environment. The contraction in demand from our customers in these industries could continue to impact our customer orders and continue to have a negative impact on our operations over the 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. 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 its 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 international operations may be subject to certain risks.
Most of the products we manufacture are in facilities located in Mexico and China. These international operations may be subject to a number of risks, including:

- difficulties in staffing and managing foreign operations;
- political and economic instability (including acts of terrorism, 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;
- fluctuations in currency exchange rates, which could affect component costs, local payroll, utility and other expenses;
- our foreign locations may be impacted by hurricanes, 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.
A significant portion of our operations are in foreign locations. As a result, transactions occur in currencies other than the U.S. dollar. Exchange rate fluctuations among other currencies used by us could directly or indirectly affect our financial results. Future currency fluctuations are dependent upon a number of factors and cannot be easily predicted. We currently use Mexican peso forward contracts to hedge foreign currency fluctuations for a portion of our Mexican peso denominated expenses. However, unexpected losses could occur from future fluctuations in exchange rates. 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.

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 employees. There can be no assurance that we will be successful in attracting and retaining such personnel. The loss of key employees could have a material adverse effect on our business, operating results and financial condition.

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.

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 with interest rates based on various levels of margin added to published prime rate and LIBOR rates depending on the calculation of a certain financial covenant. 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.

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 and non-compete agreements, as a result of the acquisition of Sabre. 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' 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

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 (1)	95,000	Leased	Sales, research, administration and manufacturing
Spokane Valley, Washington	36,000	Leased	Manufacturing
El Paso, Texas	80,000	Leased	Shipping and warehouse
Total USA	211,000		
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 (2)	103,000	Owned	Manufacturing and warehouse
Juarez, Mexico (3)	193,000	Leased	Warehouse
Juarez, Mexico (4)	66,000	Leased	Manufacturing
Total Mexico	777,000		
Shanghai, China (5)	115,000	Leased	Manufacturing and warehouse
Shanghai, China	36,000	Leased	Manufacturing
Total China	151,000		
Grand Total	1,139,000		

(1) During fiscal year 2014, we amended the lease agreement whereby increasing our leased space to 95,000 square feet.

(2) During fiscal year 2012, we purchased an additional 103,000 square feet of manufacturing and warehouse space.

(3) During fiscal year 2014, we amended the lease agreement whereby increasing our leased space to 193,000 square feet to accommodate additional warehouse space.

(4) During fiscal year 2014, we completed our acquisition of Sabre Manufacturing resulting in an additional 66,000 square feet of leased manufacturing space.

(5) During fiscal year 2014, we amended the lease of our China facility whereby increasing our leased space to 115,000 square feet to accommodate additional manufacturing and warehouse space.

On September 3, 2014, the Company acquired CDR Manufacturing resulting in an increase in our manufacturing and warehouse space; however, the amount is yet to be determined.

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).

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 2014 and 2013 were as follows:

	2014		2013	
	High	Low	High	Low
First Quarter	$12.19	$9.60	$11.35	$7.15
Second Quarter	11.36	9.83	11.62	8.69
Third Quarter	11.44	9.81	12.28	9.36
Fourth Quarter	10.99	10.00	12.12	10.16

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 June 28, 2014, we had 721 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 2014.

	6/27/2009	7/3/2010	7/2/2011	6/30/2012	6/29/2013	6/28/2014
Key Tronic Corporation	100.00	295.76	273.94	499.39	627.27	650.30
NASDAQ Composite	100.00	117.06	154.79	167.05	197.48	259.41
NASDAQ Electronic Components	100.00	119.12	151.74	143.59	160.15	222.48

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				
	June 28, 2014	June 29, 2013	June 30, 2012	July 2, 2011	July 3, 2010
Consolidated Statements of Operations Data:					
Net sales	$305,394	$361,033	$346,475	$253,846	$199,620
Gross profit	26,854	34,512	29,836	20,648	19,250
Gross margin percentage	8.8 %	9.6 %	8.6 %	8.1 %	9.6 %
Operating income	9,304	18,126	14,351	6,939	7,388
Operating margin percentage	3.0 %	5.0 %	4.1 %	2.7 %	3.7 %
Net income	7,613	12,583	11,626	5,736	8,690
Earnings per share – diluted	0.67	1.12	1.07	0.55	0.85
Consolidated Cash Flow Data:					
Cash flows provided by (used in) operations	1,458	29,282	(5,066)	(2,569)	3,534
Capital expenditures	7,763	3,470	4,654	3,818	3,378
Consolidated Balance Sheet Data:					
Net working capital [1]	71,049	73,827	76,236	58,307	44,708
Total assets	156,660	135,130	150,912	112,364	101,642
Long-term liabilities	848	3,030	19,050	11,063	4,236
Shareholders' equity	103,645	94,160	78,608	68,023	59,417
Book value per share [2]	$9.83	$8.97	$7.50	$6.54	$5.79
Supplemental Data:					
Number of shares outstanding at year-end	10,546,750	10,502,188	10,481,356	10,399,187	10,264,390
Number of employees at year-end	3,343	2,584	2,700	1,997	2,036
Approximate square footage of operational facilities	1,139,000	1,011,000	945,000	796,000	987,000

(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.

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

While fiscal year 2014 was a challenging year with respect to our total revenue, we continued to make significant progress in ramping up our new programs, expanding our customer base and extending our capabilities. Throughout the year, our revenue was impacted by slowdowns and delays from certain longstanding customers. At the same time, we saw the continued ramp up of our new programs, while maintaining operating efficiencies and a strong balance sheet.

Net sales of $305.4 million for fiscal year 2014 decreased by 15.4 percent as compared to net sales of $361.0 million in fiscal year 2013. The decrease in net sales was primarily driven by the overall decrease in demand related to current customer programs. At the end of fiscal year 2014, we were generating revenue from 196 separate programs and 59 distinct customers as compared to 183 programs and 56 customers at the end of fiscal year 2013. These new customers have programs that represent small annual sales while others have multi-million-dollar potential. Moving into the first quarter of fiscal 2015, our new customer programs continue to steadily ramp up and we expect to see renewed sequential growth. Furthermore, our acquisition of CDR Manufacturing on September 3, 2014, represents a major step forward for Key Tronic, significantly growing our revenue and extending capabilities and customer base worldwide. Excluding the potential impact of the acquisition of CDR manufacturing in fiscal year 2015, the Company expects to report revenue in the range of $76 million to $82 million for the first quarter of fiscal year 2015. 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.

The concentration of our largest customers decreased during fiscal year 2014 with the top five customers' sales decreasing to 62 percent of total sales in 2014 from 71 percent in 2013, and 73 percent in 2012. 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, electronic whiteboards, medical, educational, irrigation, automotive, transportation management, robotics, RFID, power supply, off-road vehicle equipment, fitness equipment, HVAC controls, and consumer products.

Gross profit as a percent of sales was 8.8 percent in fiscal year 2014 compared to 9.6 percent for the prior fiscal year. This 0.8 percentage point decrease in gross profit as a percentage of net sales during fiscal year 2014 as compared to fiscal year 2013 is primarily related to a 5.1 percentage point increase in certain overhead costs as we brought on additional headcount and equipment to support new customer programs, partially offset by a 4.3 percentage point improvement in material 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 sales for fiscal year 2014 was 3.0 percent compared to 5.0 percent for fiscal year 2013. The decrease in operating income as a percentage of net sales was primarily due to a decrease in gross margin and a slight increase in headcount in program management and engineering to support new program wins and

anticipated future growth.

Net income for fiscal year 2014 was $7.6 million or $0.67 per diluted share, as compared to net income of $12.6 million or $1.12 per diluted share for fiscal year 2013. The decrease in net income for fiscal year 2014 as compared to fiscal year 2013 was primarily due to a decrease in demand from some of our large, longstanding customers as well as an increase in certain overhead costs as a percentage of net sales, partially offset by a decrease in material-related costs as a percentage of net sales.

We maintain a strong balance sheet with a current ratio of 2.4 and currently have no bank debt apart from $7.9 million outstanding under a factoring agreement described in Note 5. Total cash provided by operating activities as defined on our cash flow statement was $1.5 million during fiscal year 2014. We maintain sufficient liquidity for our expected future operations. We did not have an outstanding balance on our revolving line of credit with Wells Fargo Bank, N.A. as of June 28, 2014. As a result, $30.0 million remained available to borrow as of June 28, 2014. We believe cash flow from operations, our borrowing capacity, our accounts receivable sale program, and equipment lease financing should provide adequate capital for planned growth over the long term.

RESULTS OF OPERATIONS

Comparison of the Fiscal Year Ended June 28, 2014 with the Fiscal Year Ended June 29, 2013

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 28, 2014	% of net sales	June 29, 2013	% of net sales	$ change	% point change
Net sales	$305,394	100.0%	$361,033	100.0%	$(55,639)	—
Cost of sales	278,540	91.2	326,521	90.4	(47,981)	0.8
Gross profit	26,854	8.8	34,512	9.6	(7,658)	(0.8)
Operating expenses:						
Research, development and engineering	5,586	1.8	5,156	1.4	430	0.4
Selling, general and administrative	11,964	3.9	11,230	3.1	734	0.8
Total operating expenses	17,550	5.7	16,386	4.5	1,164	1.2
Operating income	9,304	3.0	18,126	5.0	(8,822)	(2.0)
Interest expense, net	81	—	271	0.1	(190)	(0.1)
Income before income taxes	9,223	3.0	17,855	4.9	(8,632)	(1.9)
Income tax provision	1,610	0.5	5,272	1.5	(3,662)	(1.0)
Net income	$7,613	2.5%	$12,583	3.5%	$(4,970)	(1.0)
Effective income tax rate	17.5 %		29.5 %			

Net Sales

The decrease in net sales from prior year was primarily driven by an approximate $67.4 million decrease in revenues related to decreased demand from current customer programs, an approximate $5.2 million decrease in revenues related to program losses, partially offset by a $17.0 million increase in revenues related to new program wins and the revenue generated from the acquisition of Sabre.

The following table shows the revenue by industry sectors as a percentage of revenue for fiscal years 2014 and 2013:

	Fiscal Year Ended	
	June 28, 2014	June 29, 2013
Consumer	30%	24%
Communication	23	29
Industrial and Commercial Printer	17	8
Gaming	15	22
Transaction Printer	11	11
Computer and Peripheral	4	6
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 will continue to see a change in the industry concentrations of our revenue.

Sales to foreign locations outside the United States represented 35.3 percent, and 31.8 percent of our total net sales in fiscal years 2014, and 2013, respectively.

Cost of Sales

Total cost of sales as a percentage of net sales was 91.2 percent and 90.4 percent in fiscal years 2014, and 2013, respectively.

Total cost of materials as a percentage of net sales was approximately 64.5 percent and 68.5 percent in fiscal years 2014 and 2013, respectively. The change from year-to-year is primarily the result of a change in product mix and to a lesser degree improved pricing of certain raw materials.

Production and support costs as a percentage of net sales were 26.7 percent and 21.9 percent in fiscal years 2014 and 2013, respectively. The increase in fiscal year 2014 is primarily related to adding headcount and manufacturing capacity to support new programs.

We provide a reserve for obsolete and non-saleable inventories based on specific identification of inventory against current demand and recent usage. The amounts charged to expense for these inventories were approximately $0.3 million, and $0.5 million in fiscal years 2014 and 2013, 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 $35,000 and $26,000 in fiscal years 2014 and 2013, respectively.

Gross Profit

Gross profit as a percentage of net sales was 8.8 percent and 9.6 percent in fiscal years 2014, and 2013, respectively. The 0.8 percentage point decrease in gross profit as a percentage of net sales during fiscal year 2014 as compared to fiscal year 2013 is primarily related to a 5.1 percentage point increase in certain overhead costs, partially offset by a 4.3 percentage point improvement 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 $1.1 million and $0.9 million in fiscal years 2014 and 2013, 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 $5.6 million and $5.2 million in fiscal years 2014 and 2013, respectively. This $0.4 million increase is primarily the result of an increase in payroll related expenses as additional headcount was necessary to support new program wins and anticipated future growth.

Total RD&E expenses as a percent of net sales were 1.8 percent and 1.4 percent in fiscal years 2014 and 2013, respectively. This 0.4 percentage point increase in RD&E is primarily related to a slight increase in headcount in program management and engineering to support new program wins and anticipated future growth coupled with the decline in revenue.

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 $12.0 million and $11.2 million in fiscal years 2014 and 2013, respectively. This $0.7 million increase is primarily related to an increase in payroll related expenses due to increased headcount. In addition, SG&A expenses for fiscal year 2013, included a positive impact of a non-recurring adjustment of approximately $0.5 million related to the reversal of a deferred compensation liability.

Total SG&A expenses as a percent of net sales were 3.9 percent and 3.1 percent in fiscal years 2014 and 2013, respectively. This 0.8 percent percentage point increase in SG&A is primarily related to an increase in labor related expenses and the decrease in net sales.

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Interest Expense

We had net interest expense of $0.1 million and $0.3 million in fiscal years 2014 and 2013, respectively. This decrease in interest expense is primarily related to a decrease in the average balance outstanding on our line of credit and to a lesser extent paying down existing capital leases.

Income Tax Provision

We had an income tax expense of $1.6 million during fiscal year 2014 as compared to an income tax expense of $5.3 million in fiscal year 2013. The income tax expense recognized during both fiscal years 2014 and 2013 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 revenue growth and to look for potential future acquisitions. We continue to anticipate repatriating a portion of our unremitted foreign earnings. The associated taxes and potential 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 an SMT, assembly and molding facility, newly acquired sheet metal fabrication, and five assembly and storage facilities in Juarez, Mexico. 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 $107.7 million, $115.0 million and $140.8 million in fiscal years 2014, 2013 and 2012, respectively. Products and manufacturing services provided by our subsidiary operations are primarily sold to customers directly by the parent company. Key Tronic Computer Peripherals (Shanghai) Co., Ltd., our subsidiary in Shanghai, China, had only minimal direct sales to customers in China during the past two fiscal years.

RESULTS OF OPERATIONS

Comparison of the Fiscal Year Ended June 29, 2013 with the Fiscal Year Ended June 30, 2012

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 29, 2013	% of net sales	June 30, 2012	% of net sales	$ change	% point change
Net sales	$361,033	100.0%	$346,475	100.0%	$14,558	—
Cost of sales	326,521	90.4	316,639	91.4	9,882	(1.0)
Gross profit	34,512	9.6	29,836	8.6	4,676	1.0
Operating expenses:						
Research, development and engineering	5,156	1.4	4,444	1.3	712	0.1
Selling, general and administrative	11,230	3.1	11,041	3.2	189	(0.1)
Total operating expenses	16,386	4.5	15,485	4.5	901	—
Operating income	18,126	5.0	14,351	4.1	3,775	0.9
Interest expense, net	271	0.1	510	0.1	(239)	—
Income before income taxes	17,855	4.9	13,841	4.0	4,014	0.9
Income tax provision	5,272	1.5	2,215	0.6	3,057	0.9
Net income	$12,583	3.5%	$11,626	3.4%	$957	0.1
Effective income tax rate	29.5 %		16.0 %			

Net Sales

The increase in net sales from prior year was primarily driven by an approximate $11.7 million increase in revenues related to new programs for both new and longstanding customers and to a lesser extent a net $5.5 million increase related to increased demand from current customer programs, which was partially offset by the slowdown from the large customer that began to reduce production levels in the second quarter of fiscal year 2013. In addition, the increases were negatively impacted by $2.6 million related to customer program losses. The negative impact resulting from the previously discussed slowdown of demand from one of our larger customers is reflected in the analysis above.

The following table shows the revenue by industry sectors as a percentage of revenue for fiscal years 2013 and 2012:

	Fiscal Year Ended	
	June 29, 2013	June 30, 2012
Communication	29%	36%
Consumer	24	20
Gaming	22	18
Transaction Printer	11	12
Industrial and Commercial Printer	8	7
Computer and Peripheral	6	7
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 31.8 percent, and 40.6 percent of our total net sales in fiscal years 2013, and 2012, respectively.

Cost of Sales

Total cost of sales as a percentage of net sales was 90.4 percent and 91.4 percent in fiscal years 2013, and 2012, respectively.

Total cost of materials as a percentage of net sales was approximately 68.5 percent and 70.4 percent in fiscal years 2013 and 2012, respectively. The change from year-to-year is primarily the result of a change in product mix and to a lesser degree improved pricing of certain raw materials.

Production and support costs as a percentage of net sales were 21.9 percent, and 21.0 percent in fiscal years 2013 and 2012, respectively. The increase in fiscal year 2013 is primarily related to adding headcount and manufacturing capacity to support new programs.

We provide a reserve for obsolete and non-saleable inventories based on specific identification of inventory against current demand and recent usage. The amounts charged to expense for these inventories were approximately $0.5 million, and $0.8 million in fiscal years 2013 and 2012, 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 $26,000 and $65,000 in fiscal years 2013 and 2012, respectively.

Gross Profit

Gross profit as a percentage of net sales was 9.6 percent and 8.6 percent in fiscal years 2013, and 2012, respectively. The 1.0 percentage point increase in gross profit as a percentage of net sales during fiscal year 2013 as compared to fiscal year 2012 is primarily related to a 1.9 percentage point improvement in material costs, as a percent of sales, 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 $946,000 and $932,000 in fiscal years 2013 and 2012, 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 $5.2 million and $4.4 million in fiscal years 2013 and 2012, respectively. This $0.7 million increase is primarily the result of an increase in payroll related expenses as additional headcount was necessary to support new programs as they ramp up.

Total RD&E expenses as a percent of net sales were 1.4 percent and 1.3 percent in fiscal years 2013 and 2012, respectively. This 0.1 percentage point increase in RD&E is primarily related to our deleveraging of operating expenses as a percent of net sales.

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 $11.2 million and $11.0 million in fiscal years 2013 and 2012, respectively. This $0.2 million increase is primarily related to an increase in payroll related expenses due to increased headcount and higher incentive compensation as compared to the prior year. This increase is partially offset by the positive impact of a non-recurring adjustment of approximately $0.5 million related to the elimination of a deferred compensation liability.

Total SG&A expenses as a percent of net sales were 3.1 percent and 3.2 percent in fiscal years 2013 and 2012, respectively. This 0.1 percent percentage point improvement in SG&A is primarily related to our continued success in leveraging operating expenses as a percent of net sales.

Interest Expense

We had net interest expense of $0.3 million and $0.5 million in fiscal years 2013 and 2012, respectively. This decrease is primarily related to a decrease in the average balance outstanding on our line of credit during the year and the impact of not having an outstanding balance on our line of credit at fiscal year end 2013.

Income Tax Provision

We had an income tax expense of $5.3 million during fiscal year 2013 as compared to an income tax expense of $2.2 million in fiscal year 2012. The income tax expense recognized during both fiscal 2013 and 2012 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 and changes in potential foreign tax credits. The impact of this offset was greater in 2012 because the Company recognized a benefit related to federal research and development tax credits during fiscal 2012, due to the results of a multi-year tax credit study performed during that year. Fiscal 2013 recognized credits were related to expenses incurred during the current year.

Due to increased profitability, revenue growth, and new customer programs, we utilized all remaining domestic and foreign net operating loss carryforwards (NOLs) during fiscal year 2012. As a result, there was no remaining deferred tax asset as of June 30, 2012 related to NOLs. In addition, we continually review our requirements for liquidity domestically to fund revenue growth and to look for potential future acquisitions. We continue to anticipate repatriating a portion of our unremitted foreign earnings. The associated taxes and potential 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 2014 was $1.5 million compared to net cash provided by operating activities of $29.3 million and net cash used in operating activities of $5.1 million in fiscal years 2013 and 2012, respectively.

The working capital year-over-year change is primarily related to a $10.5 million increase in inventory, a $2.7 million increase in accounts receivable, partially offset by a $6.1 million increase in accounts payable. The working capital changes during fiscal year 2013 are primarily due to a $13.3 million decrease in inventory and a $13.6 million decrease in accounts receivable, which were partially offset by a $16.6 million decrease in accounts payable. Accounts receivable fluctuates based on the timing of shipments, terms offered and collections. Accounts payable fluctuates with changes in inventory levels, volume of inventory purchases, negotiated supplier terms, and taking advantage of early pay discounts. We purchase inventory based on customer forecasts and orders, and when those forecasts and orders change, the amount of inventory may also fluctuate.

Investing Cash Flow

Cash flows used in investing activities were $13.8 million, $3.3 million, and $4.6 million in fiscal years 2014, 2013 and 2012, respectively. Our primary investing activity during fiscal year 2014 was the acquisition of Sabre as discussed in further detail in Footnote 14 of the "Notes to Consolidated Financial Statements." In addition, investing cash flows consists of capital expenditures to purchase sheet metal and plastic injection molding equipment to support production.

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.

Financing Cash Flow

Cash flows provided by financing activities were $7.3 million in fiscal year 2014 as compared to cash flows used in financing activities of $15.7 million and cash flows provided by financing activities of $9.0 million in fiscal years 2013 and 2012, respectively. Our primary financing activities in fiscal years 2014, 2013, and 2012 was borrowing and repayment under our revolving line of credit facility and principal payments on our capital lease obligations. Our credit agreement with Wells Fargo Bank, N.A. provides a revolving line of credit facility of up to $30.0 million. The agreement specifies that the proceeds of the revolving line of credit be used primarily for working capital and general corporate purposes of the Company and its subsidiaries. The Company did not have an outstanding balance on the line of credit as of June 28, 2014. We had availability to borrow $30.0 million under the Wells Fargo line of credit and we were in compliance with our loan covenants. During fiscal year 2014, cash provided by financing activities also reflected payments of $0.6 million on capital leases. Additionally, the Company received $7.9 million in cash as a result of our accounts receivable purchase program with Wells Fargo Bank, N.A. during fiscal year 2014. The Company did not receive any cash related to the accounts receivable purchase program during fiscal years 2013 and

2012.

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

As of June 28, 2014, we had approximately $0.8 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 June 28, 2014 would approximate $82,000. The Company also has approximately $23.8 million of foreign earnings that has not been repatriated back to the U.S. Of that amount, the Company estimates that $10.5 million is to be repatriated in the future, requiring U.S. taxes of $1.5 million that is currently accrued in our deferred tax liabilities. The remaining $13.3 million is considered to be permanently reinvested in Mexico and China. If these amounts were required to be repatriated it would create an additional $2.8 million 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	2015	2016	2017	2018	2019	Thereafter
Wells Fargo Bank N.A. revolving loan [1]	$—	$—	$—	$—	$—	$—	$—
Operating leases [2]	8,169	2,806	1,776	900	755	757	1,175
Purchase orders [3]							

(1) 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 June 28, 2014, 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.

(2) We maintain vertically integrated manufacturing operations in Mexico and China. We lease some of our administrative and manufacturing facilities. 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, clean rooms, and automated insertion, and test equipment for the various products we are capable of producing.

(3) As of June 28, 2014, we had open purchase order commitments for materials and other supplies of approximately $47.7 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. In addition, we have contracts with 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.

On September 3, 2014, the Company acquired CDR Manufacturing resulting in an increase in our operating leases; however, the amount is yet to be determined.

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 $32.5 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. Also, the Company had a net liability of $7.9 million to WFB for accounts receivables transferred as of June 28, 2014.

We believe that cash flows generated from operations, 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

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.

Allowance for Doubtful Accounts

We value our accounts receivable net of an allowance for doubtful accounts. As of June 28, 2014, we deemed that no allowance was necessary. The allowance for doubtful accounts was $40,000 as of June 29, 2013. This allowance is based on estimates of the portion of accounts receivable that may not be collected in the future. The estimates used are based primarily on specific identification of potentially uncollectible accounts. Such accounts are identified using publicly available information in conjunction with evaluations of current payment activity. However, if any of our customers were to develop unexpected and immediate financial problems that would prevent payment of open invoices, we could incur additional and possibly material expenses that would negatively impact earnings.

Accrued Warranty

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

Income Taxes

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 current or long-term based on the classification of the related asset or liability. 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.

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 is secured by substantially all of our assets. The interest rates applicable to our revolving credit facility fluctuate with the Wells Fargo Bank, N.A. prime rate and LIBOR rates. The Company did not have an outstanding balance on the line of credit as of June 28, 2014. 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.

In addition, we are subject to market risk related to our trade accounts receivable transfer program. The interest rates applicable to our trade accounts receivable transfer program fluctuate with the Wells Fargo Bank, N.A. LIBOR rates. As of June 28, 2014, the Company had a net liability to WFB of $7.9 million. See “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Capital Resources and Liquidity” and Note 5 – “Trade Accounts Receivable Transfer Program” to the Consolidated Financial Statements for additional information.

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 $62.4 million of foreign currency forward contracts outstanding as of June 28, 2014. The fair value of these contracts was approximately $3.6 million. See Note 11 – “Derivative Financial Instruments” to the Consolidated Financial Statements for additional information regarding our derivative instruments.

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 June 28, 2014 and June 29, 2013 and the related consolidated statements of income, comprehensive income, shareholders' equity, and cash flows for each of the three years in the period ended June 28, 2014. 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 June 28, 2014 and June 29, 2013, and the results of its operations and its cash flows for each of the three years in the period ended June 28, 2014, 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 June 28, 2014, based on criteria established in Internal Control - Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated September 5, 2014 expressed an unqualified opinion thereon.

/s/ BDO USA, LLP

Spokane, Washington
September 5, 2014

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

	June 28, 2014	June 29, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	$5,803	$10,819
Trade receivables, net	49,658	47,009
Inventories	55,634	44,664
Deferred income tax asset	935	1,767
Other	11,186	7,508
Total current assets	123,216	111,767
Property, plant and equipment, net	23,596	17,911
Other assets:		
Deferred income tax asset	3,325	3,179
Other	2,712	2,273
Goodwill	1,740	—
Other intangible assets	2,071	—
Total other assets	9,848	5,452
Total assets	$156,660	$135,130
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$32,459	$26,400
Accrued compensation and vacation	7,562	7,413
Current portion of debt	7,853	576
Other	4,293	3,551
Total current liabilities	52,167	37,940
Long-term liabilities:		
Deferred income tax liability	270	1,585
Other long-term obligations	578	1,445
Total long-term liabilities	848	3,030
Total liabilities	53,015	40,970
Commitments and contingencies (Note 4 and 9)		
Shareholders’ equity:		
Common stock, no par value—shares authorized 25,000; issued and outstanding 10,547 and 10,502 shares, respectively	44,151	43,369
Retained earnings	57,091	49,478
Accumulated other comprehensive income	2,403	1,313
Total shareholders’ equity	103,645	94,160
Total liabilities and shareholders’ equity	$156,660	$135,130

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		
	June 28, 2014	June 29, 2013	June 30, 2012
Net sales	$305,394	$361,033	$346,475
Cost of sales	278,540	326,521	316,639
Gross profit	26,854	34,512	29,836
Research, development and engineering expenses	5,586	5,156	4,444
Selling, general and administrative expenses	11,964	11,230	11,041
Total operating expenses	17,550	16,386	15,485
Operating income	9,304	18,126	14,351
Interest expense, net	81	271	510
Income before income taxes	9,223	17,855	13,841
Income tax provision	1,610	5,272	2,215
Net income	$7,613	$12,583	$11,626
Net income per share — Basic	$0.72	$1.20	$1.11
Weighted average shares outstanding — Basic	10,528	10,490	10,447
Net income per share — Diluted	$0.67	$1.12	$1.07
Weighted average shares outstanding — Diluted	11,358	11,252	10,838

See accompanying notes to consolidated financial statements.

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

	Fiscal Year Ended		
	June 28, 2014	June 29, 2013	June 30, 2012
Comprehensive income:			
Net income	$7,613	$12,583	$11,626
Other comprehensive income:			
Unrealized gain (loss) on foreign exchange contracts, net of tax	1,090	1,972	(2,399)
Comprehensive income	$8,703	$14,555	$9,227

Other comprehensive income for fiscal years 2014, 2013, and 2012 is reflected net of tax expense (benefit) of approximately $0.6 million, $1.0 million and $(1.2) million, respectively.
See accompanying notes to consolidated financial statements.

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

	Fiscal Year Ended		
	June 28, 2014	June 29, 2013	June 30, 2012
Operating activities:			
Net income	$7,613	$12,583	$11,626
Adjustments to reconcile net income to cash provided by (used in) operating activities:			
Depreciation and amortization	3,829	2,965	2,333
Excess tax benefit from exercise of stock options	(73)	(103)	(509)
Provision for obsolete inventory	257	525	762
Provision for warranty	35	26	60
Provision for (recovery of) doubtful accounts	37	62	(111)
Loss on disposal of fixed assets	12	27	5
Share-based compensation expense	659	848	624
Deferred income taxes	(687)	2,493	221
Deferred compensation	—	(546)	—
Changes in operating assets and liabilities, net of acquisition:			
Trade receivables	(2,686)	13,638	(20,268)
Inventories	(10,450)	13,250	(17,647)
Other assets	(3,145)	(2,381)	(1,732)
Accounts payable	6,059	(16,625)	16,876
Accrued compensation and vacation	149	1,148	1,829
Other liabilities	(151)	1,372	865
Cash provided by (used in) operating activities	1,458	29,282	(5,066)
Investing activities:			
Payment for acquisition	(6,027)	—	—
Purchase of property and equipment	(7,763)	(3,470)	(4,654)
Proceeds from sale of fixed assets	—	27	9
Proceeds from life insurance	—	144	—
Cash used in investing activities	(13,790)	(3,299)	(4,645)
Financing activities:			
Payment of financing costs	(84)	(75)	(75)
Principal payments on capital lease obligations	(576)	(729)	(689)
Borrowings under revolving credit agreement	8,212	66,528	114,591
Repayment of revolving credit agreement	(8,212)	(81,539)	(105,580)
Proceeds from accounts receivable purchase agreement	7,853	—	—
Excess tax benefit from exercise of stock options	73	103	509
Proceeds from exercise of stock options	50	46	225
Cash (used in) provided by financing activities	7,316	(15,666)	8,981
Net (decrease) increase in cash and cash equivalents	(5,016)	10,317	(730)
Cash and cash equivalents, beginning of period	10,819	502	1,232
Cash and cash equivalents, end of period	$5,803	$10,819	$502
Supplemental cash flow information:			
Interest payments	$90	$317	$443
Income tax payments, net of refunds	$2,184	$2,708	$1,412

See accompanying notes to consolidated financial statements.

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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, July 2, 2011	10,399	$41,014	$25,269	$ 1,740	$68,023
Net Income	—	—	11,626	—	11,626
Unrealized loss on foreign exchange contracts, net	—	—	—	(2,399)	(2,399)
Exercise of stock options	82	225	—	—	225
Share-based compensation	—	624	—	—	624
Tax benefit from exercise of stock options	—	509	—	—	509
Balances, June 30, 2012	10,481	$42,372	$36,895	$ (659)	$78,608
Net Income	—	—	12,583	—	12,583
Unrealized gain on foreign exchange contracts, net	—	—	—	1,972	1,972
Exercise of stock options	21	46	—	—	46
Share-based compensation	—	848	—	—	848
Tax benefit from exercise of stock options	—	103	—	—	103
Balances, June 29, 2013	10,502	$43,369	$49,478	$ 1,313	$94,160
Net income	—	—	7,613	—	7,613
Unrealized gain on foreign exchange contracts, net	—	—	—	1,090	1,090
Exercise of stock options	45	50	—	—	50
Share-based compensation	—	659	—	—	659
Tax benefit from exercise of stock options	—	73	—	—	73
Balances, June 28, 2014	10,547	$44,151	$57,091	$ 2,403	$103,645

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 Spokane Valley; Juarez, Mexico; and Shanghai, China.

Principles of Consolidation

The consolidated financial statements include the Company and its wholly owned subsidiaries in Mexico and China. Intercompany balances and transactions have been eliminated in 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, 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, and the fair values of options and stock appreciation rights granted under the Company's stock-based compensation plans. 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.

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. Internally constructed molds and dies are depreciated over the expected useful lives of one to two years. Repairs and maintenance costs are expensed as incurred.

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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.

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 plan. The Company contracted with a separate administrative service company to supervise and administer the program and act as its representative. The Company reduces its risk under this self-funded platform by purchasing stop-loss insurance coverage for 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 3.4 percent, 2.5 percent and 2.1 percent of total revenue in fiscal years 2014, 2013, and 2012, 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 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 transacts business in Mexico and is subject to the risk of foreign currency exchange rate fluctuations. The Company enters into foreign currency forward contracts to manage the foreign currency fluctuations for Mexican peso denominated payroll, utility, tax, and accounts payable expenses. The foreign currency forward contracts 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 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 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 June 28, 2014 and June 29, 2013, reasonably approximate their fair value. As of June 28, 2014 and June 29, 2013, the Company did not have an outstanding balance on the line of credit.

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 and selling, general, and administrative expenses.

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Newly Adopted and Recent Accounting Pronouncements

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

In January 2013, the FASB issued Accounting Standards Update 2013-01 (ASU 2013-01), Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities. The main objective in developing this Update is to address implementation issues about the scope of Accounting Standards Update No. 2011-11, Balance Sheet Topic 210: Disclosures about Offsetting Assets and Liabilities. The amendments are effective for fiscal years beginning on or after January 1, 2013, and interim periods within those annual periods. The amendments of ASU 2013-01 did not have a material impact on the Company's consolidated financial statements.

In February 2013, the FASB issued Accounting Standards Update 2013-02 (ASU 2013-02), Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. The objective of this Update is to improve the reporting of reclassifications out of accumulated other comprehensive income. The amendments in this Update seek to attain that objective by requiring an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under U.S. GAAP to be reclassified in its entirety to net income. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under U.S. GAAP that provide additional detail about those amounts. The amendments are effective prospectively for annual reporting periods beginning after December 15, 2012 and interim periods within those annual periods. The amendments of ASU 2013-02 did not have a material impact on the Company's consolidated financial statements.

In July 2013, the FASB issued Accounting Standards Update 2013-11 (ASU 2013-11), Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists a consensus of the FASB Emerging Issues Task Force. The objective of this Update is to eliminate the diversities that exist in financial statement presentation. The amendments aim at attaining this objective by giving explicit guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. The amendments in this Update are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The amendments of ASU 2013-11 did not have a material impact on the Company's consolidated financial statements.

In May 2014, the 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, 2016, 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.

Management has assessed the potential impact of recently issued, but not yet effective, accounting standards and determined that the provisions are either not applicable to the Company, or are not anticipated to have a material impact on the 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 2014, 2013, and 2012, ended on June 28, 2014, June 29, 2013, and June 30, 2012, respectively and each year was a 52 week year.

2. INVENTORIES

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

	June 28, 2014	June 29, 2013
Finished goods	$5,826	$7,097
Work-in-process	7,068	5,098
Raw materials and supplies	42,740	32,469
	$55,634	$44,664

3. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consists of the following:

	Life (in years)	June 28, 2014 (in thousands)	June 29, 2013
Land	—	$2,670	$2,629
Buildings and improvements	3 to 30	19,839	18,919
Equipment	1 to 10	44,257	37,317
Furniture and fixtures	3 to 5	3,029	2,730
		69,795	61,595
Accumulated depreciation		(46,199)	(43,684)
		$23,596	$17,911

4. LONG-TERM DEBT

Note Payable - Bank

On October 15, 2010, the Company entered into an amended credit agreement with Wells Fargo Bank, N.A. thereby increasing its revolving line of credit for up to $30.0 million. On November 8, 2013, the Company entered into a third amendment to the credit agreement extending the term to October 15, 2018. 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.

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

As of June 28, 2014, the Company had availability to borrow $30.0 million under the line of credit. The Company did not have an outstanding balance on the line of credit as of June 28, 2014 or June 29, 2013.

5. TRADE ACCOUNTS RECEIVABLE PURCHASE PROGRAM

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 of $50.0 million. The initial term of the agreement is 36 months with successive 12 month renewal terms. For the year ended June 28, 2014, total accounts receivables transferred was approximately $9.0 million. The receivables that were transferred remain on our consolidated balance sheet and the cash received was reflected as cash provided by financing activities in the consolidated statements of cash flows. As of June 28, 2014, the Company's net liability to WFB for accounts receivables transferred was $7.9 million classified as current portion of debt.

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6. INCOME TAXES

Income tax provision consists of the following:

	Fiscal Year Ended		
	June 28, 2014	June 29, 2013	June 30, 2012
	(in thousands)		
Current income tax provision:			
United States	$1,220	$1,729	$1,483
Foreign	1,017	1,050	511
	2,237	2,779	1,994
Deferred income tax provision:			
United States	1,566	2,049	(85)
Foreign	(2,193)	444	306
	(627)	2,493	221
Total income tax provision	$1,610	$5,272	$2,215

The Company has total tax credit carryforwards of approximately $9.3 million at June 28, 2014. Included in total tax credits carryforwards is approximately $5.1 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 2014 or 2013. The Company currently estimates that future repatriations from foreign subsidiaries will approximate $10.5 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 estimated to be approximately $4.9 million. Both the domestic tax and estimated withholding tax have been recorded as part of deferred taxes as of June 28, 2014. Included in tax credits is $3.4 million related to foreign tax credits that can be used to offset future domestic income tax. 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 $13.3 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 $2.8 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		
	June 28, 2014	June 29, 2013	June 30, 2012
	(in thousands)		
Federal income tax provision at statutory rates	$3,136	$6,071	$4,706
Foreign tax rate differences	(439)	(625)	(361)
Effect of income tax credits	(202)	(340)	(2,104)
Effect of repatriation of foreign earnings, net	287	188	—
Other	330	235	436
Change in valuation allowance	—	(257)	(462)
Effect of IETU repeal	(1,502)	—	—
Income tax provision	$1,610	$5,272	$2,215

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

	Fiscal Year Ended		
	June 28, 2014	June 29, 2013	June 30, 2012
	(in thousands)		
Domestic	$4,687	$12,863	$10,666
Foreign	4,536	4,992	3,175
Income before income taxes	$9,223	$17,855	$13,841

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

	June 28, 2014	June 29, 2013
	(in thousands)	
Deferred tax assets:		
Tax credit carryforwards, net	$2,795	$3,414
Foreign subsidiaries – future tax credits	2,767	3,389
Inventory	—	131
Accruals	2,855	1,925
Fixed Assets	602	755
Other	75	185
Deferred income tax assets	$9,094	$9,799
Deferred tax liabilities:		
Foreign subsidiaries – unremitted earnings	(4,240)	(4,115)
Fixed assets	—	(1,617)
Mark-to-market adjustments	(1,237)	(678)
Other	(185)	(28)
Deferred income tax liabilities	$(5,662)	$(6,438)
Net deferred income tax assets	$3,432	$3,361
Balance sheet caption reported in:		
Current deferred income tax asset	$935	$1,767
Long-term deferred income tax asset	3,325	3,179
Current deferred income tax liability (classified as Other current liabilities)	(558)	—
Long-term deferred income tax liability	(270)	(1,585)
Net deferred income tax asset	$3,432	$3,361

The Company has R&D tax credits that approximate $5.1 million that have 20 year carryforwards before expiring. The Company’s R&D tax credits expire in various fiscal years from 2019 to 2033. The Company also has alternative minimum tax credits, which do not expire, approximating $726,000.

Uncertain Tax Positions

As of June 28, 2014, the Company had unrecognized tax benefits of $3.1 million related to its gross R&D tax credits. The unrecognized tax benefits relate to certain R&D tax credits generated from 1999 to 2013.

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

	Fiscal Year Ended		
	June 28, 2014	June 29, 2013	June 30, 2012
	(in thousands)		
Beginning Balance	$3,031	$3,003	$781
Additions based on tax positions related to the current year	41	97	2,222
Reductions for tax provisions of the prior years	—	(69)	—
Ending Balance	$3,072	$3,031	$3,003

The increase from the prior year is due to additional R&D credits that were recorded in 2014 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, 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)		
	June 28, 2014	June 29, 2013	June 30, 2012
Net income	$7,613	$12,583	$11,626
Weighted average shares outstanding– basic	10,528	10,490	10,447
Effect of dilutive common stock options and awards	830	762	391
Weighted average shares outstanding – diluted	11,358	11,252	10,838
Earnings per share – basic	$0.72	$1.20	$1.11
Earnings per share – diluted	$0.67	$1.12	$1.07
Antidilutive options not included in diluted earnings per share	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 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.

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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 June 28, 2014, 208,166 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

On July 25, 2012, the Company granted 210,666 SARs under the 2010 Incentive Plan to certain key employees and outside directors at a strike price of $7.44 and a grant date fair value of $3.71, as of June 28, 2014, 203,166 remain outstanding. The grant date fair value for the awards granted during fiscal year 2013 were estimated using the Black Scholes option valuation method with the following weighted average assumptions as July 25, 2012:

	Fiscal Year 2013
	July 25, 2012
Expected dividend yield	—%
Risk – free interest rate	0.46%
Expected volatility	66.50%
Expected life	4.00

On July 27, 2011, the Company granted 184,666 SARs under the 2010 Incentive Plan to certain key employees and outside directors at a strike price of $4.40 and a grant date weighted average fair market value of $2.20, as of June 28, 2014, 172,666 remain outstanding. On January 26, 2012, the Company granted 32,000 SARs under the 2010 Incentive Plan to certain key employees at a strike price of $6.30 and grant date weighted average fair market value of $3.08, as of June 28, 2014, 25,000 remain outstanding. The grant date fair value for the awards granted during fiscal year 2012 were estimated using the Black Scholes option valuation method with the following weighted average assumptions at each of the respective grant dates:

	Fiscal Year 2012	
	January 26, 2012	July 27, 2011
Expected dividend yield	—%	—%
Risk – free interest rate	0.52%	1.16%
Expected volatility	64.90%	65.50%
Expected life	4.00	4.00

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 June 28, 2014, June 29, 2013 and June 30, 2012 was $0.7 million, $0.8 million and $0.6 million, respectively.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options, which differ significantly from the SARs, as traded options have no vesting restrictions and are fully transferable. In addition, 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 options exercised in fiscal years 2014, 2013 and 2012 was $0.4 million, $0.2 million and $0.3 million, respectively.

As of June 28, 2014, 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 1.77 years.

The following table summarizes the Company's stock options and SARs activity for all plans from June 29, 2013 through June 28, 2014:

	Shares Available For Grant	Options/SARs Outstanding	Aggregate Intrinsic Value (in thousands)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)
Balances, June 29, 2013	263,168	961,692	$4,309	$5.87	2.6
Shares authorized	—	—	—	—	—
Options/SARs granted	(213,166)	213,166	—	11.34	—
Options forfeited	19,000	(19,000)	—	6.93	—
Options exercised	—	(89,930)	406	5.14	—
Balances, June 28, 2014	69,002	1,065,928	$4,096	$7.01	1.8
Exercisable at June 28, 2014		456,930	$2,679	$5.86	0.9

Additional information regarding stock options and SARs outstanding and exercisable as of June 28, 2014, 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
$3.40 – $5.40	177,596	0.1	$4.37	4,930	$3.40
5.41 – 7.41	477,000	1.0	5.91	452,000	5.89
7.42 – 9.42	203,166	3.1	7.44	—	—
9.43 – 11.34	208,166	4.1	11.34	—	—
$3.40 to $11.34	1,065,928	1.8	$7.01	456,930	$5.86

The Company also has a defined contribution plan (401(k)) available to U.S. employees who have attained age 21. The Company contributes an amount equal to 100% of the employee’s contribution on the first 3% of the employee’s compensation and an additional 50% of the employee’s contribution on the following 2% of the employee’s compensation. Company contributions to the plan were approximately $0.6 million, $0.5 million, and $0.5 million during fiscal years 2014, 2013, and 2012, respectively.

9. COMMITMENTS AND CONTINGENCIES

Leases: As of June 28, 2014, 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 and $1.9 million during fiscal years 2013 and 2012, respectively. The related depreciation expense was $0.3 million for fiscal years 2014, 2013 and 2012. As of June 28, 2014, the Company has operating leases for certain equipment and production facilities, which expire at various dates during the next ten years.

Future minimum payments under non-cancelable operating leases with initial or remaining terms of one year or more at June 28, 2014, are summarized as follows (in thousands):

Fiscal Years Ending	Operating Leases
2015	$2,806
2016	1,776
2017	900
2018	755
2019	757
Thereafter	1,175
Total minimum lease payments	$8,169

On September 3, 2014, the Company acquired CDR Manufacturing resulting in an increase in our operating leases; however, the amount is yet to be determined.

Rental expense under operating leases was approximately $1.8 million, $1.5 million, and $1.5 million during fiscal years 2014, 2013, and 2012, 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 June 28, 2014, the reserve for warranty costs was approximately $11,000.

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 2014, 2013 and 2012 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 June 28, 2014 and June 29, 2013.

The following table summarizes the Company's financial assets and liabilities (only those required to be measured at fair value on a recurring basis) at fair value as of June 28, 2014 and June 29, 2013 (in thousands):

	June 28, 2014			
	Level 1	Level 2	Level 3	Total Fair Value
Financial Assets:				
Foreign currency forward contracts	$—	$3,641	$—	$3,641

	June 29, 2013			
	Level 1	Level 2	Level 3	Total Fair Value
Financial Assets:				
Foreign currency forward contracts	$—	$2,429	$—	$2,429
Financial Liabilities:				
Foreign currency forward contracts	$—	$(434)	$—	$(434)

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

The carrying values of cash and cash equivalents, accounts receivable and current liabilities reflected on the balance sheets at June 28, 2014 and June 29, 2013, reasonably approximate their fair value. The Company's long-term debt primarily consists of a revolving line of credit. Borrowings under this revolving line of credit bear interest at 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). Each of these rates is a variable floating rate dependent upon current market conditions and the Company's current credit risk. As a result of the determinable market rate for our revolving credit debt it is classified within Level 2 of the fair value hierarchy. The Company did not have an outstanding balance on the line of credit as of June 28, 2014 or June 29, 2013. Additionally, the Company has current debt related to its accounts receivable purchase program. Borrowings under this purchase program bear interest at daily one month LIBOR plus 2.25%. As a result of the determinable market rate for our accounts receivable purchase program it is classified within Level 2 of the fair value hierarchy. As of June 28, 2014, the Company had a net liability to WFB of $7.9 million, which reasonably approximates its fair value.

11. DERIVATIVE FINANCIAL INSTRUMENTS

As of June 28, 2014, the Company had outstanding foreign currency forward contracts of $62.4 million. These contract maturity dates extend through June 2017. As of June 28, 2014, the net amount of existing gains expected to be reclassified into earnings within the next 12 months is $1.4 million. 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. During the fiscal year ended June 29, 2013, the Company entered into $34.7 million of foreign currency forward contracts and settled $22.7 million of such contracts. During the fiscal year ended June 30, 2012, the Company entered into $41.1 million of foreign currency forward contracts and settled $21.2 million of such contracts. Subsequent to June 28, 2014, the Company entered into $5.4 million of additional foreign currency forward contracts that extended our hedge position through September 2017.

The following table summarizes the fair value of derivative instruments in the Consolidated Balance Sheets as of June 28, 2014 and June 29, 2013 (in thousands):