

SPARTON CORP  
Form 10-Q  
February 02, 2016  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended December 27, 2015

Or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission File Number 1-1000

Sparton Corporation  
(Exact name of registrant as specified in its charter)

Ohio  
(State or other jurisdiction of  
incorporation or organization)  
425 N. Martingale Road, Suite 1000,  
Schaumburg, Illinois  
(Address of principal executive offices)  
(847) 762-5800  
(Registrant's telephone number, including area code)

38-1054690  
(I.R.S. Employer  
Identification No.)  
60173-2213  
(Zip code)

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

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

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

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

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

As of January 29, 2016, there were 9,892,131 shares of common stock, \$1.25 par value per share, outstanding.

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements.

## SPARTON CORPORATION AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except share data)

|   | December 27,<br>2015<br>(Unaudited) | June 30,<br>2015 |
|---|-------------------------------------|------------------|
| Assets  |                                     |                  |
| Current Assets:   |                                     |                  |
| Cash and cash equivalents   | \$4,830                             | \$14,914         |
| Accounts receivable, net of allowance for doubtful accounts of \$672 and \$173, respectively                                      | 56,225                              | 70,974           |
| Inventories and cost of contracts in progress, net  | 76,717                              | 79,503           |
| Deferred income taxes   | 4,714                               | 4,714            |
| Prepaid expenses and other current assets   | 7,677                               | 5,488            |
| Total current assets  | 150,163                             | 175,593          |
| Property, plant and equipment, net  | 33,839                              | 32,608           |
| Goodwill  | 77,265                              | 74,175           |
| Other intangible assets, net  | 41,563                              | 45,825           |
| Deferred income taxes   | 2,372                               | 2,199            |
| Other assets  | 7,192                               | 7,151            |
| Total assets  | \$312,394                           | \$337,551        |
| Liabilities and Shareholders' Equity  |                                     |                  |
| Current Liabilities:  |                                     |                  |
| Accounts payable  | \$26,776                            | \$29,948         |
| Accrued salaries and wages  | 7,941                               | 9,089            |
| Accrued health benefits   | 1,516                               | 1,510            |
| Performance based payments on customer contracts  | 1,867                               | 1,756            |
| Other accrued expenses  | 13,058                              | 16,328           |
| Total current liabilities   | 51,158                              | 58,631           |
| Pension liability   | 424                                 | 424              |
| Long-term debt  | 133,800                             | 154,500          |
| Environmental remediation   | 6,708                               | 7,117            |
| Total liabilities   | 192,090                             | 220,672          |
| Commitments and contingencies   |                                     |                  |
| Shareholders' Equity:   |                                     |                  |
| Preferred stock, no par value; 200,000 shares authorized, none issued   | —                                   | —                |
| Common stock, \$1.25 par value; 15,000,000 shares authorized, 9,892,131 and 9,886,618 shares issued and outstanding, respectively | 12,365                              | 12,358           |
| Capital in excess of par value  | 16,927                              | 16,045           |
| Retained earnings   | 92,595                              | 89,933           |
| Accumulated other comprehensive loss  | (1,583                              | ) (1,457         |
| Total shareholders' equity  | 120,304                             | 116,879          |
| Total liabilities and shareholders' equity  | \$312,394                           | \$337,551        |

See Notes to unaudited consolidated financial statements.



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SPARTON CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME  
(UNAUDITED)

(Dollars in thousands, except share and per share data)

|  | For the Second Quarter of Fiscal |           | For the First Two Quarters of |           |
|--|----------------------------------|-----------|-------------------------------|-----------|
|  | Years                            |           | Fiscal Years                  |           |
|  | 2016                             | 2015      | 2016                          | 2015      |
| Net sales                                    | \$103,529                        | \$85,642  | \$210,220                     | \$162,667 |
| Cost of goods sold                           | 85,008                           | 70,436    | 170,561                       | 134,608   |
| Gross profit                                 | 18,521                           | 15,206    | 39,659                        | 28,059    |
| Operating Expense:                           |                                  |           |                               |           |
| Selling and administrative expenses          | 14,340                           | 10,792    | 27,964                        | 21,376    |
| Internal research and development expenses   | 438                              | 197       | 951                           | 297       |
| Amortization of intangible assets            | 2,459                            | 1,485     | 4,962                         | 2,825     |
| Restructuring charges                        | 2,360                            | —         | 2,360                         | —         |
| Reversal of accrued contingent consideration | (1,530)                          | ) —       | (1,530)                       | ) —       |
| Total operating expense                      | 18,067                           | 12,474    | 34,707                        | 24,498    |
| Operating income                             | 454                              | 2,732     | 4,952                         | 3,561     |
| Other income (expense)                       |                                  |           |                               |           |
| Interest expense, net                        | (900)                            | ) (357)   | (1,783)                       | ) (1,101) |
| Other, net                                   | 34                               | (46)      | ) 102                         | 100       |
| Total other expense, net                     | (866)                            | ) (403)   | (1,681)                       | ) (1,001) |
| Income (loss) before income taxes            | (412)                            | ) 2,329   | 3,271                         | 2,560     |
| Income taxes                                 | (680)                            | ) 767     | 609                           | 802       |
| Net income                                   | \$268                            | \$1,562   | \$2,662                       | \$1,758   |
| Income per share of common stock:            |                                  |           |                               |           |
| Basic  | \$0.03                           | \$0.16    | \$0.27                        | \$0.17    |
| Diluted                                      | \$0.03                           | \$0.16    | \$0.27                        | \$0.17    |
| Weighted average shares of common stock      |                                  |           |                               |           |
| outstanding:                                 |                                  |           |                               |           |
| Basic  | 9,783,237                        | 9,894,526 | 9,781,884                     | 9,927,672 |
| Diluted                                      | 9,783,237                        | 9,910,735 | 9,781,884                     | 9,946,833 |

See Notes to unaudited consolidated financial statements.

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SPARTON CORPORATION AND SUBSIDIARIES  
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
 (UNAUDITED)  
 (Dollars in thousands)

|  | For the Second Quarter of<br>Fiscal Years |         | For the First Two Quarters of<br>Fiscal Years |         |
|--|---|---------|---|---------|
|  | 2016                                      | 2015    | 2016  | 2015    |
| Net income   | \$268                                     | \$1,562 | \$2,662                                       | \$1,758 |
| Other comprehensive income, net:                                 |   |         |   |         |
| Amortization of unrecognized net actuarial loss, net<br>of tax   | 40  | 5       | 47  | 25      |
| Unrecognized loss on marketable equity securities,<br>net of tax | (102                                      | ) (58   | ) (173  | ) (58   |
| Other comprehensive loss, net                                    | (62                                       | ) (53   | ) (126  | ) (33   |
| Comprehensive income   | \$206                                     | \$1,509 | \$2,536                                       | \$1,725 |
| See Notes to unaudited consolidated financial statements.        |   |         |   |         |

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SPARTON CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(UNAUDITED)  
(Dollars in thousands)

|   | For the First Two Quarters of Fiscal<br>Years |           |
|---|---|-----------|
|   | 2016  | 2015      |
| Cash Flows from Operating Activities:   |   |           |
| Net income  | \$2,662                                       | \$1,758   |
| Adjustments to reconcile net income to net cash provided by operating activities: |   |           |
| Depreciation  | 3,007   | 2,221     |
| Amortization of intangible assets   | 4,962   | 2,825     |
| Deferred income taxes   | 36  | 58        |
| Stock-based compensation expense  | 869   | 1,218     |
| Gross profit effect of capitalized profit in inventory from acquisitions          | —   | 178       |
| Reversal of accrued contingent consideration                                      | (1,530  | ) —       |
| Excess tax benefit from stock-based compensation                                  | (161  | ) (974    |
| Amortization of deferred financing costs  | 140   | 511       |
| Changes in operating assets and liabilities (net of acquisitions):                |   |           |
| Accounts receivable   | 14,363  | 12,845    |
| Inventories and cost of contracts in progress                                     | (2,266  | ) 1,467   |
| Prepaid expenses and other assets   | (2,567  | ) (2,162  |
| Performance based payments on customer contracts                                  | 111   | (1,788    |
| Accounts payable and accrued expenses   | (6,517  | ) (9,368  |
| Net cash provided by operating activities   | 13,109  | 8,789     |
| Cash Flows from Investing Activities:   |   |           |
| Acquisition of businesses, net of cash acquired                                   | 750   | (21,745   |
| Marketable securities   | —   | (986      |
| Purchases of property, plant and equipment  | (3,263  | ) (1,828  |
| Net cash used in investing activities   | (2,513  | ) (24,559 |
| Cash Flows from Financing Activities:   |   |           |
| Borrowings of long-term debt  | 46,300  | 65,724    |
| Repayments of long-term debt  | (67,000                                       | ) (48,224 |
| Payment of debt financing costs   | —   | (1,057    |
| Repurchase of stock   | (141  | ) (6,451  |
| Proceeds from the exercise of stock options                                       | —   | 12        |
| Excess tax benefit from stock-based compensation                                  | 161   | 974       |
| Net cash (used in) provided by financing activities                               | (20,680                                       | ) 10,978  |
| Net decrease in cash and cash equivalents   | (10,084                                       | ) (4,792  |
| Cash and cash equivalents at beginning of period                                  | 14,914  | 8,028     |
| Cash and cash equivalents at end of period  | \$4,830                                       | \$3,236   |
| Supplemental disclosure of cash flow information:                                 |   |           |
| Cash paid for interest  | \$1,508                                       | \$571     |
| Cash paid for income taxes  | \$766   | \$2,395   |
| Supplemental disclosure of non-cash investing activities:                         |   |           |
| Adjustments to acquired companies opening balance sheets                          | \$3,840                                       | \$1,976   |



See Notes to unaudited consolidated financial statements.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except share and per share data)

## (1) Business and Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Certain reclassifications of prior year amounts have been made to conform to the current year presentation. Subsequent events have been evaluated through the date these financial statements were issued. Additionally, the consolidated financial statements should be read in conjunction with Item 2 of Management's Discussion and Analysis of Financial Condition and Results of Operations, included in this Quarterly Report on Form 10-Q.

For fiscal year 2016, the Company has changed from a calendar year to a 52-53 week year (5-4-4 basis) ending on the Sunday closest to June 30. Therefore, the financial results of certain fiscal years, and the associated 14 week quarters, will not be exactly comparable to the prior and subsequent 52 week fiscal years and the associated quarters having only 13 weeks. The change was not deemed a change in fiscal year for purposes of reporting subject to Rule 13a-10 or 15d-10; hence, no transition reports are required. The Company has made the change in fiscal years on a prospective basis and thus will not impact the Company's financial statements as of and for the year ended June 30, 2015 or any interim period therein. The Company believes the change in fiscal years will provide numerous benefits, including more consistency between reported periods and to better align its reporting periods with the Company's peer group. The consolidated balance sheet at June 30, 2015 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended June 30, 2015.

## (2) Acquisitions

The company consummated seven acquisitions in fiscal year 2015. The following table summarizes the pro forma results of operations had the acquisitions occurred as of the beginning of the 2015 fiscal year:

|                                | For the Second<br>Quarter of Fiscal<br>Year<br>2015 | For the First Two<br>Quarters of Fiscal<br>Year<br>2015 |
|--------------------------------|---|---|
| Net sales                      | \$107,952   | \$212,282   |
| Net income                     | 2,289   | 3,803   |
| Net income per share — basic   | 0.23  | 0.38  |
| Net income per share — diluted | 0.23  | 0.38  |

Certain of the acquisitions included contingent consideration liabilities based on future earnings. During the second quarter of fiscal year 2016, the Company determined that Hunter Technology Corporation ("Hunter") and Real-Time Enterprises, Inc. ("RTEmd") would not meet the required performance thresholds necessary to earn their respective contingent considerations. As a result, the Company recorded non-cash income associated with the reversal of contingent considerations of \$1,180 and \$350 for Hunter and RTEmd, respectively.

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The Company has elected to adopt Accounting Standards Update No. 2015-16, Business Combinations (Topic 805) Simplifying the Accounting for Measurement-Period Adjustment. As a result, during the first two quarters of fiscal 2016, the Company recorded adjustments to the opening balance sheets of Hunter and RTEmd as follows:

Changes to goodwill:

|  |         |   |
|--|---------|---|
| Inventory                                  | \$5,052 |   |
| Accounts receivable                        | 386     |   |
| Property, plant and equipment              | (974    | ) |
| Intangible assets - customer relationships | (700    | ) |
| Other assets and liabilities, net          | 76      |   |
| Non-cash adjustments                       | 3,840   |   |
| Adjustment to purchase consideration       | (750    | ) |
| Total                                      | \$3,090 |   |

For the second quarter of fiscal year 2016, the Company recorded depreciation expense of \$362 in cost of goods sold and amortization of intangible assets of \$26 that would have otherwise been recorded in prior periods.

Certain of the acquisitions included escrow accounts based on final working capital adjustments and other performance criteria. During the second quarter of fiscal year 2016, the Company received \$750 in adjustments to the purchase price under the terms of an acquisition agreement, as reflected in the table above.

(3) Inventories and Cost of Contracts in Progress

The following are the major classifications of inventory, net of interim billings:

|  | December 27,<br>2015 | June 30,<br>2015 |
|--|----------------------|------------------|
| Raw materials  | \$47,922             | \$60,668         |
| Work in process  | 20,810               | 19,047           |
| Finished goods   | 12,299               | 7,244            |
| Total inventory and cost of contracts in progress, gross                 | 81,031               | 86,959           |
| Inventory to which the U.S. government has title due to interim billings | (4,314               | ) (7,456         |
| Total inventory and cost of contracts in progress, net                   | \$76,717             | \$79,503         |

(4) Property, Plant and Equipment, Net

Property, plant and equipment, net consists of the following:

|  | December 27,<br>2015 | June 30,<br>2015 |
|--|----------------------|------------------|
| Land and land improvements               | \$1,429              | \$1,429          |
| Buildings and building improvements      | 27,564               | 27,482           |
| Machinery and equipment                  | 40,780               | 36,923           |
| Construction in progress                 | 1,471                | 2,278            |
| Total property, plant and equipment      | 71,244               | 68,112           |
| Less accumulated depreciation            | (37,405              | ) (35,504        |
| Total property, plant and equipment, net | \$33,839             | \$32,608         |

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## (5) Other Intangible Assets

The components of other intangible assets, net consist of the following:

|                              | Net Carrying<br>Value at<br>June 30, 2015 | Additions | Amortization | Net Carrying<br>Value at<br>December 27,<br>2015 |
|------------------------------|---|-----------|--------------|--|
| Non-compete agreements       | \$3,129                                   | \$—       | \$(477)      | ) \$2,652  |
| Customer relationships       | 40,126                                    | 700       | (4,250)      | ) 36,576   |
| Trademarks/Tradenames        | 1,551                                     | —         | (87)         | ) 1,464  |
| Unpatented technology        | 1,019                                     | —         | (148)        | ) 871  |
| Other intangible assets, net | \$45,825                                  | \$700     | \$(4,962)    | ) \$41,563                                       |

## (6) Debt

The Company has a revolving line-of-credit facility (the “Credit Facility”) of \$275,000, which can be expanded by up to \$100,000. The facility is secured by substantially all assets of the Company and its subsidiaries and expires on September 11, 2019.

Outstanding borrowings under the Credit Facility will bear interest, at the Company’s option, at either LIBOR, fixed for interest periods of one, two, three or six month periods, plus 1.00% to 1.75%, or at the bank’s base rate, as defined, plus 0.00% to 0.75%, based upon the Company’s Total Funded Debt/EBITDA Ratio, as defined. The Company is also required to pay commitment fees on unused portions of the Credit Facility ranging from 0.20% to 0.35%, based on the Company’s Total Funded Debt/EBITDA Ratio, as defined. The Credit Facility includes representations, covenants and events of default that are customary for financing transactions of this nature. The effective interest rate on outstanding borrowings under the Credit Facility was 2.30% at December 27, 2015. As a condition of the Credit Facility, the Company is subject to certain customary covenants, which it was in compliance with at December 27, 2015.

As of December 27, 2015, the Company had approximately \$140,656 available under its \$275,000 credit facility, reflecting borrowings of \$133,800 and certain letters of credit outstanding of \$544.

## (7) Fair Value Measurements

The Financial Accounting Standards Board (“FASB”) ASC topic entitled Fair Value Measurements and Disclosures defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). The accounting guidance classifies the inputs used to measure fair value as follows: Level 1 - unadjusted quoted prices in active markets for the identical asset or liability, Level 2 - observable inputs for the asset or liability, either directly or indirectly, such as quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs other than quoted prices that are observable for the asset or liability, and Level 3 - unobservable inputs for the asset or liability.

The fair value of the Company’s Credit Facility (See Note 6, Debt) approximates its carrying value as the rates on these borrowings are variable and repriced based on current market conditions. Due to the current nature of the Company’s accounts receivable and accounts payable, their fair values approximate their carrying value.

The Company holds marketable equity securities of \$579 and \$846 at December 27, 2015 and June 30, 2015, respectively, that it classifies as available-for-sale and are recorded in other non-current assets on the Consolidated Balance Sheets. These securities are carried at fair value with unrealized gains and losses reflected in Accumulated Other Comprehensive Income and are classified as Level 1 in the fair value hierarchy.

## (8) Income Taxes

The Company recognized a discrete income tax benefit of \$536 in the second quarter of fiscal year 2016 as a result of the reversal of previously accrued contingent purchase price consideration liability. The Company’s effective income

tax rate for interim periods was determined based on the Company's estimated annual effective tax rate for the applicable year using the federal statutory income tax rate, permanent tax differences, foreign income taxes and state income taxes. Excluding the

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discrete income tax event described above, the Company's estimated annual effective tax rate for the fiscal year was determined to be approximately 35.0%

## (9) Defined Benefit Pension Plan

The Company has a frozen defined benefit pension plan. The Company recorded net periodic pension expense of \$12 for the second quarter of fiscal year 2016 and net periodic pension income of \$67 for the second quarter of fiscal 2015. The Company recorded net periodic pension income of \$23 and \$77 for the first two quarters of fiscal years 2016 and 2015, respectively. No contributions were made to the pension plan during fiscal years 2016 and 2015.

## (10) Commitments and Contingencies

From time to time, the Company is involved in various legal proceedings relating to claims arising in the ordinary course of business. The Company is not currently a party to any such legal proceedings, the adverse outcome of which, individually or in the aggregate, is expected to have a material adverse effect on the Company's financial condition or results of operations. Additionally, the Company believes it has sufficient insurance coverage to effectively mitigate any litigation exposure. On October 1, 2015, the Company settled an outstanding legal matter with L-3 for \$2,500. The settlement amount was fully accrued on the Company's consolidated balance sheet as of September 27, 2015.

The Company is a party to an environmental remediation matter in Albuquerque, New Mexico. As of December 27, 2015 and June 30, 2015, Sparton had accrued approximately \$7,383 and \$7,792, respectively, as its estimate of the remaining minimum future discounted financial liability regarding this matter, of which approximately \$675 is classified as a current liability and included on the balance sheets in other accrued expenses. See the Company's annual report as filed on Form 10-K for further information.

The Company is subject to audits by certain federal government agencies, including the Defense Contract Audit Agency and the Defense Contract Management Agency. The agencies audit and evaluate government contracts and government contractors' administrative processes and systems. These agencies review the Company's performance on contracts, pricing practices, cost structure, financial capability and compliance with applicable laws, regulations and standards. They also review the adequacy of the Company's internal control systems and policies, including the Company's purchasing, accounting, estimating, compensation and management information processes and systems. The Company works closely with these agencies to ensure compliance. From time to time, the Company is notified of claims related to noncompliance arising from the audits performed by agencies. Such claims have historically been subject to actions of remediation and/or financial claims that are typically subject to negotiated settlements. The Company believes that it has appropriate reserves established for outstanding issues and is not aware of any other issues of noncompliance that would have a material effect on the Company's financial position or results of operations.

## (11) Stock-Based Compensation

The Company has a long-term incentive plan to offer incentive and non-qualified stock options, stock appreciation rights, restricted stock or restricted stock units, performance awards and other stock-based awards, including grants of shares under the Sparton Corporation 2010 Long-Term Incentive Plan (the "2010 Plan").

The following table shows stock-based compensation expense by type of share-based award included in the consolidated statements of income:

|   | For the Second Quarter of Fiscal Years |        | For the First Two Quarters of Fiscal Years |          |
|---|--|--------|--|----------|
|   | 2016                                   | 2015   | 2016                                       | 2015     |
| Fair value expense of stock option awards | \$ 195                                 | \$ 103 | \$ 317                                     | \$ 141   |
| Restricted stock units                    | 349                                    | 209    | 567  | 285      |
| Restricted stock                          | (107                                   | ) 457  | (15  | ) 792    |
| Total stock-based compensation expense    | \$ 437                                 | \$ 769 | \$ 869                                     | \$ 1,218 |

During the first and second quarters of fiscal year 2016, the Company awarded an aggregate of 129,798 stock options to certain members of management with an average exercise price of \$22.98, of which 5,076 stock options were

granted during the second quarter of fiscal year 2016. The fair value of each stock option is estimated at the grant date using the Black-Scholes option pricing method.

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The following is a summary of activity for the first two quarters of fiscal year 2016 related to the 2010 plan:

|                                  | Stock Options | Restricted<br>stock units | Restricted<br>shares |
|----------------------------------|---------------|---------------------------|----------------------|
| Outstanding at June 30, 2015     | 107,584       | 62,828                    | 132,299              |
| Granted                          | 129,798       | 96,904                    | —                    |
| Forfeited                        | (13,745 )     | (3,242 )                  | (2,630 )             |
| Vested                           | (19,420 )     | —                         | (27,345 )            |
| Outstanding at December 27, 2015 | 204,217       | 156,490                   | 102,324              |

As of December 27, 2015, 19,420 stock options were exercisable.

## (12) Earnings Per Share Data

The following table sets forth the computation of basic and diluted net income per share:

|   | For the Second Quarter of<br>Fiscal Years |           | For the First Two Quarters of<br>Fiscal Years |           |
|---|---|-----------|---|-----------|
|   | 2016                                      | 2015      | 2016  | 2015      |
| Numerator:  |   |           |   |           |
| Net income  | \$268                                     | \$1,562   | \$2,662                                       | \$1,758   |
| Less net income (loss) allocated to contingently issuable<br>participating securities | (3 )                                      | (22 )     | (28 )   | (26 )     |
| Net income available to common shareholders   | \$265                                     | \$1,540   | \$2,634                                       | \$1,732   |
|   |   |           |   |           |
| Weighted average shares outstanding – Basic   | 9,783,237                                 | 9,894,526 | 9,781,884                                     | 9,927,672 |
| Dilutive effect of stock options  | —   | 16,209    | —   | 19,161    |
| Weighted average shares outstanding – Diluted   | 9,783,237                                 | 9,910,735 | 9,781,884                                     | 9,946,833 |
|   |   |           |   |           |
| Net income available to common shareholders per share:                                |   |           |   |           |
| Basic   | \$0.03                                    | \$0.16    | \$0.27  | \$0.17    |
| Diluted   | \$0.03                                    | \$0.16    | \$0.27  | \$0.17    |

For the second quarters of fiscal years 2016 and 2015, there were no unvested participating restricted shares included in determining both basic and diluted earnings per share. For the first two quarters of fiscal years 2016 and 2015, 102,324 and 175,666, respectively, of unvested participating restricted shares were included in determining both basic and diluted earnings per share. Potential common shares, excluded from the calculation of diluted net income per share because they were either contingently issuable or their inclusion would be anti-dilutive, were 463,031 for the first two quarters of fiscal year 2016.



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## (13) Restructuring Activities

During the second quarter of fiscal 2016, the Company announced the closing of its Lawrenceville, GA manufacturing operations and the consolidation of its Irvine, CA design center into its Irvine, CA manufacturing operations. These restructuring activities are expected to be completed no later than June 30, 2016 and February 29, 2016, respectively, and were taken to optimize the Company's manufacturing and design facility footprint and realize synergies from the Company's acquisitions.

The table below summarizes the nature and amount of all restructuring actions for the second quarter of fiscal 2016:

|   | Termination<br>Benefits | Exit / Other<br>Costs | Total   |
|---|-------------------------|-----------------------|---------|
| Restructuring reserve as of June 30, 2015     | \$—                     | \$—                   | \$—     |
| Provision                                     | 820                     | 1,540                 | 2,360   |
| Payments                                      | —                       | (600                  | ) (600  |
| Restructuring reserve as of December 27, 2015 | \$820                   | \$940                 | \$1,760 |

## (14) Business Segments

The Company has identified two reportable segments; Manufacturing & Design Services and Engineered Components & Products. The Company uses an internal management reporting system, which provides important financial data to evaluate performance and allocate the Company's resources on a segment basis. The Company's Chief Operating Decision Maker (CODM) assesses segment performance and allocates resources to each segment individually.

Operating results and certain other financial information about the Company's two reportable segments for the second quarter and first two quarters of fiscal years 2016 and 2015 were as follows:

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## For the Second Quarter of Fiscal Year 2016

|  | MDS       | ECP      | Unallocated | Eliminations | Total     |
|--|-----------|----------|-------------|--------------|-----------|
| Net sales                                    | \$67,586  | \$40,642 | \$—         | \$(4,699 )   | \$103,529 |
| Gross profit                                 | 6,989     | 11,532   | —           | —            | 18,521    |
| Selling and administrative expenses          | 6,646     | 3,715    | 3,979       | —            | 14,340    |
| Internal research and development expenses   | —         | 438      | —           | —            | 438       |
| Restructuring charges                        | 2,360     | —        | —           | —            | 2,360     |
| Reversal of accrued contingent consideration | (1,530 )  | —        | —           | —            | (1,530 )  |
| Depreciation and amortization                | 3,337     | 663      | 274         | —            | 4,274     |
| Operating income (loss)                      | (2,524 )  | 6,957    | (3,979 )    | —            | 454       |
| Capital expenditures                         | 427       | 228      | 1,128       | —            | 1,783     |
| Total assets at December 27, 2015            | \$231,190 | \$87,193 | \$37,882    | \$(43,871 )  | \$312,394 |

## For the Second Quarter of Fiscal Year 2015

|  | MDS       | ECP      | Unallocated | Eliminations | Total     |
|--|-----------|----------|-------------|--------------|-----------|
| Net sales                                  | \$60,790  | \$28,919 | \$—         | \$(4,067 )   | \$85,642  |
| Gross profit                               | 8,208     | 6,998    | —           | —            | 15,206    |
| Selling and administrative expenses        | 4,133     | 2,445    | 4,214       | —            | 10,792    |
| Internal research and development expenses | —         | 197      | —           | —            | 197       |
| Depreciation and amortization              | 2,115     | 294      | 179         | —            | 2,588     |
| Operating income                           | 2,673     | 4,273    | (4,214 )    | —            | 2,732     |
| Capital expenditures                       | 347       | 416      | 52          | —            | 815       |
| Total assets at June 30, 2015              | \$238,777 | \$64,880 | \$33,894    | \$—          | \$337,551 |

## For the First Two Quarters of Fiscal Year 2016

|  | MDS       | ECP      | Unallocated | Eliminations | Total     |
|--|-----------|----------|-------------|--------------|-----------|
| Net sales                                    | \$141,543 | \$78,731 | \$—         | \$(10,054 )  | \$210,220 |
| Gross profit                                 | 17,285    | 22,374   | —           | —            | 39,659    |
| Selling and administrative expenses          | 12,527    | 7,312    | 8,125       | —            | 27,964    |
| Internal research and development expenses   | —         | 951      | —           | —            | 951       |
| Restructuring charges                        | 2,360     | —        | —           | —            | 2,360     |
| Reversal of accrued contingent consideration | (1,530 )  | —        | —           | —            | (1,530 )  |
| Depreciation and amortization                | 6,152     | 1,327    | 490         | —            | 7,969     |
| Operating income (loss)                      | (183 )    | 13,260   | (8,125 )    | —            | 4,952     |
| Capital expenditures                         | 1,433     | 273      | 1,557       | —            | 3,263     |

## For the First Two Quarters of Fiscal Year 2015

|  | MDS | ECP | Unallocated | Eliminations | Total |
|--|-----|-----|-------------|--------------|-------|
|--|-----|-----|-------------|--------------|-------|

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|  |           |          |         |           |             |
|--|-----------|----------|---------|-----------|-------------|
| Net sales                                  | \$117,041 | \$51,988 | \$—     | \$(6,362) | ) \$162,667 |
| Gross profit                               | 15,294    | 12,765   | —       | —         | 28,059      |
| Selling and administrative expenses        | 7,862     | 4,757    | 8,757   | —         | 21,376      |
| Internal research and development expenses | —         | 297      | —       | —         | 297         |
| Depreciation and amortization              | 4,174     | 586      | 286     | —         | 5,046       |
| Operating income                           | 4,779     | 7,539    | (8,757) | ) —       | 3,561       |
| Capital expenditures                       | 747       | 878      | 203     | —         | 1,828       |

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## (15) New Accounting Standards

In May 2014, the FASB issued Accounting Standards Update No. 2014-09 ("ASU 2014-09"), Revenue from Contracts with Customers, which amends guidance for revenue recognition. Under the new standard, revenue will be recognized when control of the promised goods or services is transferred to customers in an amount that reflects the consideration to which the Company expects to be entitled in exchange for those goods and services. The standard creates a five-step model that will generally require companies to use more judgment and make more estimates than under current guidance when considering the terms of contracts along with all relevant facts and circumstances. These include the identification of customer contracts and separating performance obligations, the determination of transaction price that potentially includes an estimate of variable consideration, allocating the transaction price to each separate performance obligation, and recognizing revenue in line with the pattern of transfer. The standard also requires extensive additional disclosures to provide greater insight into revenues recognized and deferred, including quantitative and qualitative information about significant judgments and changes in those judgments made to determine the timing and amount of revenues recognized. The pronouncement is effective for annual reporting periods beginning after December 15, 2015. Companies have the option of using either a full or modified retrospective approach in applying this standard. The Company is currently in the process of evaluating the impact of adoption on its consolidated financial statements.

In April 2015, the FASB issued Accounting Standards Update No. 2015-03 ("ASU 2015-03"), Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs. ASU 2015-03 changes the presentation of debt issuance costs for term debt in the balance sheet by requiring the debt issuance costs to be presented as a direct deduction from the related debt liability, rather than recorded as an asset. The standard is required to be adopted by public business entities in annual periods beginning on or after December 15, 2015. Early adoption is permitted. The Company is currently in the process of evaluating the impact of adoption on its consolidated financial statements.

In July 2015, the FASB issued Accounting Standards Update No. 2015-11 ("ASU 2015-11"), Simplifying the Measurement of Inventory. ASU 2015-11 clarifies that inventory should be held at the lower of cost or net realizable value. Net realizable value is defined as the estimated selling price, less the estimated costs to complete, dispose and transport such inventory. ASU 2015-11 will be effective for fiscal years and interim periods beginning after December 15, 2016. ASU 2015-11 is required to be applied prospectively and early adoption is permitted. The Company is currently in the process of evaluating the impact of adoption on its consolidated financial statements.

In July 2015, the FASB issued Accounting Standards Update No. 2015-12 ("ASU 2015-12"), Plan Accounting: Defined Benefit Pension Plans (Topic 960), Defined Contribution Pension Plans (Topic 962), and Health and Welfare Benefit Plans (Topic 965) - I. Fully Benefit-Responsive Investment Contracts; II. Plan Investment Disclosures, and III. Measurement Date Practical Expedient. ASU 2015-12 is effective for fiscal years beginning after December 15, 2015. The Company is currently in the process of evaluating the impact of adoption on its consolidated financial statements.

In November 2015, the FASB issued Accounting Standards Update No. 2015-17 ("ASU 2015-17"), Income Taxes (Topic 740). ASU 2015-17 requires deferred tax liabilities and assets to be classified as non-current on the consolidated condensed balance sheet. ASU 2015-17 is effective for annual reporting periods beginning after December 15, 2016 and interim periods within those fiscal years and early application is permitted and may be applied either prospectively to all deferred tax liabilities and assets or retrospectively to all periods presented. The Company is currently in the process of evaluating the impact of adoption on its consolidated financial statements.

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

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

For purposes of discussion and analysis, we categorize our operations as legacy business or acquired business. We reflect operations as legacy business if the underlying operation has been included in the Company's consolidated results of operations for all periods being discussed. Certain acquired businesses may be reflected as legacy business for quarterly purposes, but may be reflected as acquired business for the annual period as the results of operations were not included for the entire prior fiscal year. The table below reflects our recent acquisitions and how the results of operations will be reflected as legacy or acquired for the quarterly and annual discussion of our results of operations.

| Company  | Acquisition Date | Quarter acquired | Reporting period discussed as Legacy Business |                         |        |
|--|------------------|------------------|---|-------------------------|--------|
|  |                  |                  | Quarterly                                     | Quarterly, year-to-date | Annual |
| Hunter Technology Corporation                    | 04/14/15         | Q4 2015          | Q1 2017                                       | Q2 2017                 | 2017   |
| Stealth.com                                      | 03/16/15         | Q3 2015          | Q4 2016                                       | Q2 2017                 | 2017   |
| KEP Marine                                       | 01/21/15         | *                | —   | —                       | —      |
| Real-Time Enterprises, Inc.                      | 01/20/15         | Q3 2015          | Q4 2016                                       | Q2 2017                 | 2017   |
| Argotec, Inc.                                    | 12/08/14         | *                | —   | —                       | —      |
| Industrial Electronic Devices, Inc. ("IED")      | 12/03/14         | *                | —   | —                       | —      |
| Electronic Manufacturing Technology, LLC ("eMT") | 07/09/14         | Q1 2015          | Q1 2016                                       | Q2 2016                 | 2016   |
| Aubrey Group, Inc.                               | 03/17/14         | Q3 2014          | Q4 2015                                       | Q2 2016                 | 2016   |
| Beckwood Services, Inc.                          | 12/11/13         | Q2 2014          | Q3 2015                                       | Q2 2016                 | 2016   |
| Aydin Displays, Inc.                             | 08/30/13         | Q1 2014          | Q2 2015                                       | Q2 2016                 | 2016   |

\* Acquisition was treated as a "tuck in acquisition" and therefore is treated as legacy business as of the date of acquisition as stand-alone financial information is not available.

## Consolidated Results of Operations

Presented below is comparative data and discussions regarding our consolidated results of operations for the second quarter and first two quarters of fiscal 2016 compared to the second quarter and first two quarters of fiscal 2015. Results of operations for any period less than one year are not necessarily indicative of results of operations that may be expected for a full year. The following discussion should be read in conjunction with the Unaudited Consolidated Financial Statements and Notes thereto included in Item 1 of this Quarterly Report on Form 10-Q.

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For the Second Quarter of Fiscal Year 2016 compared to the Second Quarter of Fiscal Year 2015  
The following table presents selected consolidated statement of income data (dollars in thousands):  
CONSOLIDATED

|  | For the Second Quarter of Fiscal Years |            |            |            |   |
|--|--|------------|------------|------------|---|
|  | 2016                                   | % of Sales | 2015       | % of Sales |   |
| Net sales:                                   |  |            |            |            |   |
| Legacy business                              | \$81,076                               | 78.3       | % \$85,642 | 100.0      | % |
| Acquired business                            | 22,453                                 | 21.7       | —          | —          |   |
| Total net sales                              | 103,529                                | 100.0      | 85,642     | 100.0      |   |
| Cost of goods sold                           | 85,008                                 | 82.1       | 70,436     | 82.2       |   |
| Gross profit                                 | 18,521                                 | 17.9       | 15,206     | 17.8       |   |
| Selling and administrative expenses          | 14,340                                 | 13.9       | 10,792     | 12.6       |   |
| Internal research and development expenses   | 438                                    | 0.4        | 197        | 0.2        |   |
| Amortization of intangible assets            | 2,459                                  | 2.4        | 1,485      | 1.8        |   |
| Restructuring charges                        | 2,360                                  | 2.3        | —          | —          |   |
| Reversal of accrued contingent consideration | (1,530)                                | ) (1.5     | ) —        | —          |   |
| Operating income                             | 454                                    | 0.4        | 2,732      | 3.2        |   |
| Other expense, net                           | (866)                                  | ) (0.8     | ) (403     | ) (0.5     | ) |
| Income (loss) before income taxes            | (412)                                  | ) (0.4     | ) 2,329    | 2.7        |   |
| Income taxes                                 | (680)                                  | ) (0.7     | ) 767      | 0.9        |   |
| Net income                                   | \$268                                  | 0.3        | % \$1,562  | 1.8        | % |

The decrease in legacy business sales reflects fluctuations in customer demand and product insourcing in the MDS segment somewhat offset by increased sonobuoy sales to foreign governments in the ECP segment.

Gross margin was virtually unchanged, positively affected in the second quarter of fiscal 2016 as compared to the same quarter last year due to increased volume and favorable product mix in the ECP segment, substantially offset by MDS segment gross margin declines, as discussed below. The increase in selling and administrative expense is due to the expenses from companies acquired in the prior year.

The increase in amortization of intangible assets relates to certain intangible assets acquired as part of the acquisitions in fiscal year 2015.

Restructuring charges relate to the announced closing of the Company's Lawrenceville, GA manufacturing operations and the consolidation of its Irvine, CA design center into its Irvine, CA manufacturing operations. These restructuring activities are expected to be completed no later than June 30, 2016 and February 29, 2016, respectively, and were taken to optimize the Company's manufacturing and design facility footprint and realize synergies from the Company's acquisitions. The restructuring charges consist of approximately \$0.8 million of termination benefits and approximately \$1.6 million of exit and other costs, all within the MDS segment. With the exception of \$0.3 million of net lease payments, all costs are expected to occur in fiscal 2016.

Accrued contingent consideration related to Hunter Technology Corporation ("Hunter") of approximately \$1.2 million and Real-Time Enterprises, Inc. ("RTEmd") of approximately \$0.3 million, both in the MDS segment, was reversed based on the Company's determination that Hunter and RTEmd would not meet the required performance thresholds necessary to earn their respective contingent considerations.

The Company recognized a discrete income tax benefit of \$0.5 million in the second quarter of fiscal year 2016 as a result of the reversal of previously accrued contingent purchase price consideration liability. The Company's effective income tax rate for interim periods was determined based on the Company's estimated annual effective tax rate for the applicable year using the federal statutory income tax rate, permanent tax differences, foreign income taxes and state income taxes. Excluding the discrete income tax event described above, the Company's estimated annual effective tax rate for the fiscal year was determined to be approximately 35.0%.



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Due to the factors described above, the Company reported net income of \$0.3 million, or \$0.03 per share for the second quarter of fiscal year 2016, compared to net income of \$1.6 million, or \$0.16 per share for the second quarter of fiscal year 2015.

**Segment Information**

The Company has two reportable segments - Manufacturing and Design Services ("MDS") and Engineered Components and Products ("ECP").

**Manufacturing and Design Services Segment**

MDS segment operations are comprised of contract design, manufacturing and aftermarket repair and refurbishment of sophisticated printed circuit card assemblies, sub-assemblies, full product assemblies and cable/wire harnesses for customers seeking to bring their intellectual property to market. Customers include OEM and ET customers serving the Medical & Biotechnology, Military & Aerospace and Industrial & Commercial markets. In manufacturing for its customers, this segment adheres to very strict military and aerospace specifications, Food and Drug Administration ("FDA") guidelines and approvals, in addition to product and process certifications.

**Engineered Components and Products Segment**

ECP segment operations are comprised of design, development and production of proprietary products for both domestic and foreign defense as well as commercial needs. Sparton designs and manufactures ASW devices known as sonobuoys for the U.S. Navy and foreign governments that meet Department of State licensing requirements. The sonobuoy product line is built to stringent military specifications and are required to meet International Tariff and Arms Regulations regulations. Our ECP segments also includes ruggedized flat panel display systems for military panel PC workstations, air traffic control and industrial and commercial marine applications.

**MDS**

The following table presents selected consolidated statement of operations data (dollars in thousands):

|  | For the Second Quarter of Fiscal Years |            |            |            |              |          |
|--|--|------------|------------|------------|--------------|----------|
|  | 2016                                   | % of Sales | 2015       | % of Sales | \$ Chg       | % Chg    |
| Net sales:                                   |  |            |            |            |              |          |
| Legacy business                              | \$42,173                               | 62.4       | % \$56,861 | 93.5       | % \$(14,688) | (25.8)%  |
| Acquired business                            | 20,773                                 | 30.7       | —          | —          | 20,773       | —        |
| Intercompany                                 | 4,640                                  | 6.9        | 3,929      | 6.5        | 711          | 18.1     |
| Total net sales                              | 67,586                                 | 100.0      | 60,790     | 100.0      | 6,796        | 11.2     |
| Gross profit                                 | 6,989                                  | 10.3       | 8,208      | 13.5       | (1,219)      | (14.9)   |
| Selling and administrative expenses          | 6,646                                  | 9.8        | 4,133      | 6.8        | 2,513        | 60.8     |
| Amortization of intangible assets            | 2,037                                  | 3.0        | 1,402      | 2.3        | 635          | 45.3     |
| Restructuring charges                        | 2,360                                  | 3.5        | —          | —          | 2,360        | —        |
| Reversal of accrued contingent consideration | (1,530)                                | (2.3)      | —          | —          | (1,530)      | —        |
| Operating income (loss)                      | \$(2,524)                              | (3.7)%     | \$2,673    | 4.4        | % \$(5,197)  | (194.4)% |

The decrease in legacy business sales was due to declines in overall customer demand, including certain programs going end-of-life, customer insourcing, customer delays and customers managing their working capital to match end-market demands. MDS backlog was approximately \$144.4 million at the end of second quarter of fiscal year 2016 compared to \$121.2 million at the end of second quarter of fiscal year 2015. Commercial orders, in general, may be rescheduled or canceled without significant penalty, and, as a result, may not be a meaningful measure of future sales. A majority of the second quarter fiscal 2016 MDS backlog is currently expected to be realized in the next 12 months. Gross profit percentage on MDS sales was negatively affected in the current quarter by increased overhead as a result of decreased volume and a shift in product mix as compared to the second quarter of the prior year. The increase in selling and administrative expense is due to the selling and administrative expenses of acquired businesses, as well as final costs related to a previously settled legal matter.



The increase in amortization of intangible assets is due to the amortization of customer relationships and non-compete agreements acquired in the acquisitions of Hunter Technology Corporation and Real-Time Enterprises, Inc..  
Restructuring

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charges relate to the previously discussed closing of the Company's Lawrenceville, GA manufacturing operations and consolidation of its Irvine, CA design center into its Irvine, CA manufacturing operations. The reversal of accrued contingent consideration relates to Hunter and RTEmd, as previously discussed.

## ECP

The following table presents selected consolidated statement of income data (dollars in thousands):

|  | For the Second Quarter of Fiscal Years |            |            |            |            |         |
|--|--|------------|------------|------------|------------|---------|
|  | 2016                                   | % of Sales | 2015       | % of Sales | \$ Chg     | % Chg   |
| Net sales:                                 |  |            |            |            |            |         |
| Legacy business                            | \$38,903                               | 95.7       | % \$28,781 | 99.5       | % \$10,122 | 35.2    |
| Acquired business                          | 1,680                                  | 4.1        | —          | —          | 1,680      | —       |
| Intercompany                               | 59                                     | 0.2        | 138        | 0.5        | (79 )      | (57.2 ) |
| Total net sales                            | 40,642                                 | 100.0      | 28,919     | 100.0      | 11,723     | 40.5    |
| Gross profit                               | 11,532                                 | 28.4       | 6,998      | 24.2       | 4,534      | 64.8    |
| Selling and administrative expenses        | 3,715                                  | 9.1        | 2,445      | 8.4        | 1,270      | 51.9    |
| Internal research and development expenses | 438                                    | 1.1        | 197        | 0.7        | 241        | —       |
| Amortization of intangible assets          | 422                                    | 1.0        | 83         | 0.3        | 339        | —       |
| Operating income                           | \$6,957                                | 17.1       | % \$4,273  | 14.8       | % \$2,684  | 62.8    |

ECP legacy business sales increased \$10.1 million as a result of increased sonobuoy sales to foreign governments of \$8.5 million, increased engineering revenue of \$2.4 million, increased revenue in the Rugged Electronics platform of \$1.9 million and increased revenue in the Precision Sensing & Measurements platform of \$0.6 million as offset by decreased sonobuoy sales to the U.S. Navy of \$3.3 million. Total sales to the U.S. Navy in the second quarters of fiscal years 2016 and 2015 were approximately \$22.1 million and \$23.0 million, respectively. For the second quarters of fiscal years 2016 and 2015, sales to the U.S. Navy accounted for 21% and 27%, respectively, of consolidated Company net sales and 54% and 80%, respectively, of ECP segment net sales. ECP backlog was approximately \$119.1 million at the end of second quarter of fiscal year 2016 compared to \$105.4 million at the end of second quarter of fiscal year 2015. A majority of the second quarter fiscal year 2016 ECP backlog is currently expected to be realized in the next 18 months.

Gross profit percentage on ECP sales was positively affected in the current year quarter by increased volume as well as product mix as compared to the prior year quarter. The increase in selling and administrative expense was due to the acquired selling and administration expenses of Stealth.com as well as professional service expenses associated with governmental audits and compliance.

The increase in amortization of intangible assets is due to the amortization of customer relationships, non-compete agreements, trademarks/tradenames and unpatented technology acquired in the acquisitions of Stealth.com, KEP Marine and IED.

Internal research and development expenses reflect costs incurred for the internal development of technologies for use in navigation, oil and gas exploration and flat panel display technology. These costs include salaries and related expenses, contract labor and consulting costs, materials and the cost of certain research and development specific equipment.

## Eliminations and Corporate Unallocated

The following table presents selected consolidated statement of income data (dollars in thousands):

|   | For the Second Quarter of Fiscal Years |            |          |          |
|---|--|------------|----------|----------|
|   | 2016                                   | 2015       | \$ Chg   | % Chg    |
| Intercompany sales elimination                  | \$(4,699 )                             | \$(4,067 ) | \$(632 ) | (15.5 )% |
| Selling and administrative expenses unallocated | 3,979                                  | 4,214      | (235 )   | (5.6 )   |

Total corporate selling and administrative expenses before allocation to operating segments were \$7.5 million and \$6.4 million for the second quarter of fiscal year 2016 and fiscal year 2015, respectively, or 7.3% and 7.5% of consolidated sales, respectively. Of these costs, \$3.5 million and \$2.2 million, respectively, were allocated to segment

operations in each of these periods.

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For the First Two Quarters of Fiscal Year 2016 compared to the First Two Quarters of Fiscal Year 2015  
The following table presents selected consolidated statement of income data (dollars in thousands):

## CONSOLIDATED

|  | For the First Two Quarters of Fiscal Years |            |              |            |   |
|--|--|------------|--------------|------------|---|
|  | 2016                                       | % of Sales | 2015         | % of Sales |   |
| Net sales:                                   |  |            |              |            |   |
| Legacy business                              | \$ 163,681                                 | 77.9       | % \$ 162,667 | 100.0      | % |
| Acquired business                            | 46,539                                     | 22.1       | —            | —          |   |
| Total net sales                              | 210,220                                    | 100.0      | 162,667      | 100.0      |   |
| Cost of goods sold                           | 170,561                                    | 81.1       | 134,608      | 82.8       |   |
| Gross profit                                 | 39,659                                     | 18.9       | 28,059       | 17.2       |   |
| Selling and administrative expenses          | 27,964                                     | 13.3       | 21,376       | 13.1       |   |
| Internal research and development expenses   | 951  | 0.5        | 297          | 0.2        |   |
| Amortization of intangible assets            | 4,962                                      | 2.3        | 2,825        | 1.7        |   |
| Restructuring charges                        | 2,360                                      | 1.1        | —            | —          |   |
| Reversal of accrued contingent consideration | (1,530)                                    | (0.7)      | —            | —          |   |
| Operating income                             | 4,952                                      | 2.4        | 3,561        | 2.2        |   |
| Other expense, net                           | (1,681)                                    | (0.8)      | (1,001)      | (0.6)      | ) |
| Income before income taxes                   | 3,271                                      | 1.6        | 2,560        | 1.6        |   |
| Income taxes                                 | 609  | 0.3        | 802          | 0.5        |   |
| Net income                                   | \$ 2,662                                   | 1.3        | % \$ 1,758   | 1.1        | % |

The increase in legacy business sales reflects increased sonobuoy sales to foreign governments partially offset by fluctuations in customer demand and product insourcing in the MDS segment.

Gross profit percentage was positively affected in the current year by increased volume and favorable product mix in the ECP segment, partially offset by MDS segment gross margin declines. The increase in selling and administrative expense is due to the expenses from companies acquired in the prior year.

The increase in amortization of intangible assets relates to certain intangible assets acquired as part of the acquisitions in fiscal year 2015. Restructuring charges relate to the previously discussed closing of the Company's Lawrenceville, GA manufacturing operations and consolidation of its Irvine, CA design center into its Irvine, CA manufacturing operations. The reversal of accrued contingent consideration relates to Hunter and RTEmd, as previously discussed. The Company recognized a discrete income tax benefit of \$0.5 million in the second quarter of fiscal year 2016 as a result of the reversal of previously accrued contingent purchase price consideration liability. The Company's effective income tax rate for interim periods was determined based on the Company's estimated annual effective tax rate for the applicable year using the federal statutory income tax rate, permanent tax differences, foreign income taxes and state income taxes. Excluding the discrete income tax event described above, the Company's estimated annual effective tax rate for the fiscal year was determined to be approximately 35.0%.

Due to the factors described above, the Company reported net income of \$2.7 million, or \$0.27 per share for the first two quarters of fiscal year 2016, compared to net income of \$1.8 million, or \$0.17 per share for the second quarter of fiscal year 2015.

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## MDS

The following table presents selected consolidated statement of operations data (dollars in thousands):

|  | For the First Two Quarters of Fiscal Years |            |             |            |              |          |
|--|--|------------|-------------|------------|--------------|----------|
|  | 2016                                       | % of Sales | 2015        | % of Sales | \$ Chg       | % Chg    |
| Net sales:                                   |  |            |             |            |              |          |
| Legacy business                              | \$89,054                                   | 62.9       | % \$110,862 | 94.7       | % \$(21,808) | (19.7)%  |
| Acquired business                            | 42,620                                     | 30.1       | —           | —          | 42,620       | —        |
| Intercompany                                 | 9,869                                      | 7.0        | 6,179       | 5.3        | 3,690        | 59.7     |
| Total net sales                              | 141,543                                    | 100.0      | 117,041     | 100.0      | 24,502       | 20.9     |
| Gross profit                                 | 17,285                                     | 12.2       | 15,294      | 13.1       | 1,991        | 13.0     |
| Selling and administrative expenses          | 12,527                                     | 8.9        | 7,862       | 6.7        | 4,665        | 59.3     |
| Amortization of intangible assets            | 4,111                                      | 2.9        | 2,653       | 2.3        | 1,458        | 55.0     |
| Restructuring charges                        | 2,360                                      | 1.6        | —           | —          | 2,360        | —        |
| Reversal of accrued contingent consideration | (1,530)                                    | (1.1)      | —           | —          | (1,530)      | —        |
| Operating income (loss)                      | \$(183)                                    | (0.1)%     | \$4,779     | 4.1        | \$(4,962)    | (103.8)% |

The decrease in legacy business sales was due to declines in overall customer demand, including certain programs going end-of-life, customer insourcing, customer delays and customers managing their working capital to match end-market demands. Gross profit percentage on MDS sales was negatively affected in the first two quarters of fiscal year 2016 by increased overhead as a result of decreased volume and a shift in product mix as compared to the same period of the prior year. The selling and administrative expense increase is primarily comprised of businesses acquired in the prior year.

The increase in amortization of intangible assets principally relates to the amortization of customer relationships and non-compete agreements from companies acquired in the prior year. Restructuring charges relate to the previously discussed closing of the Company's Lawrenceville, GA manufacturing operations and consolidation of its Irvine, CA design center into its Irvine, CA manufacturing operations. The reversal of accrued contingent consideration relates to Hunter and RTEmd, as previously discussed.

## ECP

The following table presents selected consolidated statement of income data (dollars in thousands):

|  | For the First Two Quarters of Fiscal Years |            |            |            |            |       |
|--|--|------------|------------|------------|------------|-------|
|  | 2016                                       | % of Sales | 2015       | % of Sales | \$ Chg     | % Chg |
| Net sales:                                 |  |            |            |            |            |       |
| Legacy business                            | \$74,627                                   | 94.8       | % \$51,805 | 99.6       | % \$22,822 | 44.1% |
| Acquired business                          | 3,919                                      | 5.0        | —          | —          | 3,919      | —     |
| Intercompany                               | 185  | 0.2        | 183        | 0.4        | 2          | 1.1   |
| Total net sales                            | 78,731                                     | 100.0      | 51,988     | 100.0      | 26,743     | 51.4  |
| Gross profit                               | 22,374                                     | 28.4       | 12,765     | 24.6       | 9,609      | 75.3  |
| Selling and administrative expenses        | 7,312                                      | 9.3        | 4,757      | 9.2        | 2,555      | 53.7  |
| Internal research and development expenses | 951  | 1.2        | 297        | 0.6        | 654        | —     |
| Amortization of intangible assets          | 851  | 1.1        | 172        | 0.3        | 679        | —     |
| Operating income                           | \$13,260                                   | 16.8       | % \$7,539  | 14.5       | % \$5,721  | 75.9% |

The increase in ECP legacy business sales reflects increased sonobuoy sales to foreign governments, increased engineering revenue, as well as tuck-in acquisitions sales (reflected as legacy business rather than acquired sales). Total sales to the U.S. Navy in the first two quarters of fiscal years 2016 and 2015 were approximately \$46.5 million and \$41.4 million, respectively. For the first two quarters of fiscal years 2016 and 2015, sales to the U.S. Navy accounted for 22% and 25%, respectively, of consolidated Company net sales and 59% and 80%, respectively, of ECP segment net sales.

Gross profit percentage on ECP sales was positively affected in the current year first two quarters by increased volume as well as product mix as compared to the same period last year. The selling and administrative expense increase was due to the

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acquired selling and administration expenses of Stealth.com as well as professional service expenses associated with governmental audits and compliance. .

The increase in amortization of intangible assets relates to the amortization of customer relationships, non-compete agreements, tradenames and unpatented technology acquired as part of the fiscal year 2015 Stealth.com transaction, customer relationships and tradenames acquired as part of the fiscal year 2015 KEP Marine transaction and customer relationships and non-compete agreements acquired as part of the fiscal year 2015 IED transaction.

Internal research and development expenses reflect costs incurred for the internal development of technologies for use in navigation, oil and gas exploration and flat panel display technology. These costs include salaries and related expenses, contract labor and consulting costs, materials and the cost of certain research and development specific equipment.

**Eliminations and Corporate Unallocated**

The following table presents selected consolidated statement of income data (dollars in thousands):

|   | For the First Two Quarters of Fiscal Years |            |            |          |
|---|--|------------|------------|----------|
|   | 2016                                       | 2015       | \$ Chg     | % Chg    |
| Intercompany sales elimination                  | \$(10,054 )                                | \$(6,362 ) | \$(3,692 ) | (58.0 )% |
| Selling and administrative expenses unallocated | 8,125                                      | 8,757      | (632 )     | (7.2 )   |

**Liquidity and Capital Resources**

As of December 27, 2015, the Company had approximately \$140.7 million available under its \$275.0 million credit facility, reflecting borrowings of \$133.8 million and certain letters of credit outstanding of \$0.5 million. Additionally, the Company had available cash and cash equivalents of \$4.8 million.

Outstanding borrowings under the Credit Facility will bear interest, at the Company's option, at either LIBOR, fixed for interest periods of one, two, three or six month periods, plus 1.00% to 1.75%, or at the bank's base rate, as defined, plus 0.00% to 0.75%, based upon the Company's Total Funded Debt/EBITDA Ratio, as defined. The Company is also required to pay commitment fees on unused portions of the Credit Facility ranging from 0.20% to 0.35%, based on the Company's Total Funded Debt/EBITDA Ratio, as defined. The Credit Facility includes representations, covenants and events of default that are customary for financing transactions of this nature.

As a condition of the Credit Facility, the Company is subject to certain customary covenants, with which it was in compliance at December 27, 2015.

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

| CASH FLOWS   | For the First Two Quarters of Fiscal Years |           |
|--|--|-----------|
|  | 2016                                       | 2015      |
| Operating activities, excluding changes in working capital | \$9,985                                    | \$7,795   |
| Net changes in working capital                             | 3,124                                      | 994       |
| Operating activities                                       | 13,109                                     | 8,789     |
| Investing activities                                       | (2,513 )                                   | (24,559 ) |
| Financing activities                                       | (20,680 )                                  | 10,978    |

Net changes in working capital related cash flows in the first two quarters of fiscal year 2016 primarily reflect collections of accounts receivables partially offset by decreased accounts payable and accrued expenses. Working capital related cash flows for the first two quarters of fiscal year 2015 primarily reflect collections of accounts receivable and decreased inventories, partially offset by decreased accounts payable and accrued expenses. Net cash used in investing activities for the first two quarters of fiscal year 2016 includes cash received related to the acquisition of Hunter. Cash used in investing activities for the first two quarters of fiscal year 2015 relate to the acquisition of eMT, as well as the acquisitions of Argotec and IED. Net capital expenditures for the first two quarters of fiscal year 2016 and fiscal year 2015 were approximately \$3.3 million and \$1.8 million, respectively.





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Net cash used in financing activities in the first two quarters of fiscal year 2016 reflects \$20.7 million of net payments under the Company's Credit Facility as compared to \$17.5 million in net borrowings for the first two quarters of fiscal year 2015.

Commitments and Contingencies

See Note 10, Commitments and Contingencies, of the "Notes to Unaudited Consolidated Financial Statements" in this Quarterly Report on Form 10-Q for a discussion of the Company's commitments and contingencies.

Contractual Obligations

Information regarding the Company's long-term debt obligations, environmental liability payments, operating lease payments and other commitments is provided in Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," of the Company's Annual Report on Form 10-K for fiscal year ended June 30, 2015. As of June 30, 2015, there were \$55.2 million of non-cancelable purchase orders outstanding, \$154.5 million of debt, \$12.5 million of operating lease payments and a liability related to performance based billings on customer contracts of \$1.8 million. As of December 27, 2015, the non-cancelable purchase orders outstanding has increased to \$59.8 million, debt decreased to \$133.8 million, operating lease payments increased to \$12.7 million and the liability related to performance based billings increased to \$1.9 million. Other than as noted above, there have been no material changes in the nature or amount of the Company's contractual obligations since fiscal year end 2015.

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Off-Balance Sheet Arrangements

The Company has standby letters of credit outstanding of approximately \$0.5 million at December 27, 2015, principally to support insurance arrangements. Other than these standby letters of credit and the operating lease commitments referenced above, we have no off-balance sheet arrangements that would have a current or future material effect on our financial condition, changes in financial condition, revenue, expense, results of operations, liquidity, capital expenditures or capital resources.

Critical Accounting Policies

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

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

- Revenue recognition
- Business combinations
- Goodwill and intangible assets
- Percentage-of-completion accounting
- Environmental contingencies
- Income taxes
- Commercial inventory valuation
- Allowance for probable losses on receivables
- Valuation of property, plant and equipment
- Stock-based compensation
- Pension obligations

There have been no significant changes to our critical accounting policies that are described in Part II, Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations” section of our Annual Report on Form 10-K for the year ended June 30, 2015.

New Accounting Pronouncements

See Note 15, New Accounting Standards, of the “Notes to Unaudited Consolidated Financial Statements” in this Quarterly Report on Form 10-Q for a discussion of new accounting pronouncements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

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

The Company’s revolving credit line, when drawn upon, is subject to future interest rate fluctuations which could potentially have a negative impact on cash flows of the Company. The Company had \$133.8 million outstanding under its Credit Facility at December 27, 2015. A prospective increase of 100 basis points in the interest rate applicable to the Company’s outstanding borrowings under its Credit Facility would result in an increase of approximately \$1.3 million in our



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annual interest expense. The Company is not party to any currency exchange or interest rate protection agreements as of December 27, 2015.

Item 4. Controls and Procedures.

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

There have been no changes in our internal controls over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the second quarter of fiscal year 2016 ended December 27, 2015, that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

See Note 10, Commitments and Contingencies, of the “Notes to Unaudited Consolidated Financial Statements” in this Quarterly Report on Form 10-Q for a discussion of legal proceedings and other commitments and contingencies.

Item 1A. Risk Factors.

You should carefully consider the risks and uncertainties described in Part I, Item 1A., "Risk Factors," in our Annual Report on Form 10-K for the year ended June 30, 2015 and the other information in our subsequent filings with the SEC, including this Quarterly Report on Form 10-Q. Our business, financial condition, results of operations and stock price could be materially and adversely affected by any of these risks. The risks described in our Annual Report on Form 10-K are not the only ones we face. Additional risks and uncertainties that are currently unknown to us or that we currently consider to be immaterial may also impair our business or adversely affect our financial condition, results of operations and stock price.

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Item 6. Exhibits.

| Exhibit<br>Number | Description   |
|-------------------|---|
| 3.1               | Second Amended Articles of Incorporation of the Registrant, incorporated herein by reference from the Registrant's Proxy Statement on Form DEF 14A filed with the SEC on September 21, 2010.  |
| 3.2               | Amended and Restated Code of Regulations of the Registrant, incorporated herein by reference from Exhibit 3.2 to the Registrant's Current Report on Form 8-K filed with the SEC on May 5, 2015.   |
| 10.1              | Amendment No. 1 dated March 16, 2015 to the Amended and Restated Credit and Guaranty Agreement dated September 11, 2014, entered into between B.M.O. Harris Bank, N.A., and the Borrowers, incorporated by reference from Exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q filed with the SEC on May 5, 2015. |
| 10.2              | Amendment No. 2 dated April 13, 2015 to the Amended and Restated Credit and Guaranty Agreement dated September 11, 2014, entered into between B.M.O. Harris Bank, N.A., and the Borrowers, incorporated by reference from Exhibit 10.1 to the Registrant's Current Report on Form 8-K filed with the SEC on April 17, 2015. |
| 18.1              | Preferability Letter from Independent Registered Public Accounting Firm Regarding Change in Accounting Principle, incorporated herein by reference from the Registrant's Quarterly Report on Form 10-Q filed with the SEC on November 5, 2013.  |
| 31.1*             | Chief Executive Officer certification under Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 31.2*             | Chief Financial Officer certification under Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 32.1*             | Chief Executive Officer and Chief Financial Officer certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.   |
| 101.INS*          | XBRL Instance Document  |
| 101.SCH*          | XBRL Taxonomy Extension Schema Document   |
| 101.CAL*          | XBRL Taxonomy Calculation Linkbase Document   |
| 101.DEF*          | XBRL Taxonomy Extension Definition Linkbase Document  |
| 101.LAB*          | XBRL Taxonomy Extension Label Linkbase Document   |
| 101.PRE*          | XBRL Taxonomy Extension Presentation Linkbase Document  |

\* Filed herewith.

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SIGNATURES

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

Sparton Corporation

Date: February 2, 2016

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

Date: February 2, 2016

By: /s/ JOSEPH G. MCCORMACK  
Joseph G. McCormack  
Senior Vice President and Chief Financial  
Officer  
(Principal Financial Officer)