

SPARTON CORP
Form 10-Q
November 08, 2018
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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 September 30, 2018

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 38-1054690
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)
425 N. Martingale Road, Suite 1000, 60173-2213
Schaumburg, Illinois
(Address of principal executive offices) (Zip code)
(847) 762-5800
(Registrant's telephone number, including area 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 every Interactive Data File required to be submitted 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 such files). Yes No

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

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company
Emerging growth company

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If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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 November 2, 2018, there were 9,834,723 shares of common stock, \$1.25 par value per share, outstanding.

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FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains statements about future events and expectations that are “forward-looking statements.” We may also make forward-looking statements in our other reports filed with the SEC, in materials delivered to our shareholders and in press releases. These statements relate to future events or our future financial performance and involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by these forward-looking statements. Certain of these risks, uncertainties and other factors are described in Item 1A of Part II, “Risk Factors” of our most recent Annual Report on Form 10-K. In some cases, you can identify forward-looking statements by terminology such as “may,” “will,” “should,” “expects,” “intends,” “plans,” “anticipates,” “believes,” “estimates,” “predicts,” “potential,” or the negative use of the or other comparable terminology that convey the uncertainty of future events or outcomes. Although we believe these forward-looking statements are reasonable, they are based on a number of assumptions concerning future conditions, any or all of which may ultimately prove to be inaccurate. These forward-looking statements are based on management’s views and assumptions at the time originally made, and we undertake no obligation to update these statements whether as a result of new information or future events. There can be no assurance that our expectations, projections or views will materialize and you should not place undue reliance on these forward-looking statements. Any statement in this report that is not a statement of historical fact may be deemed to be a forward-looking statement and subject to the safe harbor created by the Private Securities Litigation Reform Act of 1995.

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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)

| | September 30, 2018 | July 1, 2018 |
|---|-----------------------|-----------------|
| | (Unaudited) | |
| Assets | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 1,170 | \$1,160 |
| Accounts receivable, net of allowance for doubtful accounts of \$163 and \$169, respectively | 46,011 | 60,454 |
| Inventories and cost of contracts in progress, net | 91,230 | 72,406 |
| Legal settlements - insurance receivable | 4,500 | 4,500 |
| Prepaid expenses and other current assets | 6,823 | 3,944 |
| Total current assets | 149,734 | 142,464 |
| Property, plant and equipment, net | 32,024 | 32,790 |
| Goodwill | 12,663 | 12,663 |
| Other intangible assets, net | 19,438 | 21,108 |
| Deferred income taxes | 17,772 | 17,646 |
| Other non-current assets | 4,858 | 5,331 |
| Total assets | \$ 236,489 | \$232,002 |
| Liabilities and Shareholders' Equity | | |
| Current Liabilities: | | |
| Accounts payable | \$ 39,393 | \$28,636 |
| Accrued salaries | 8,305 | 11,341 |
| Accrued health benefits | 1,177 | 947 |
| Accrued legal settlements | 5,500 | 5,500 |
| Performance based payments on customer contracts | 13,307 | 3,868 |
| Advances from customers | 6,418 | 5,949 |
| Current portion of capital lease obligations | 100 | 163 |
| Other accrued expenses | 10,438 | 10,718 |
| Total current liabilities | 84,638 | 67,122 |
| Credit facility | 73,000 | 84,500 |
| Environmental remediation | 4,705 | 4,866 |
| Pension liability | 657 | 690 |
| Other non-current liabilities | — | 1,220 |
| Total liabilities | 163,000 | 158,398 |
| 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, 9,834,723 and 9,834,723 shares issued and outstanding, respectively | 12,293 | 12,293 |
| Capital in excess of par value | 17,586 | 17,599 |
| Retained earnings | 44,580 | 44,713 |
| Accumulated other comprehensive loss | (970) | (1,001) |
| Total shareholders' equity | 73,489 | 73,604 |
| Total liabilities and shareholders' equity | \$ 236,489 | \$232,002 |
| See Notes to unaudited consolidated financial statements. | | |

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SPARTON CORPORATION AND SUBSIDIARIES
 CONSOLIDATED STATEMENTS OF OPERATIONS
 (UNAUDITED)

(Dollars in thousands, except per share data)

| | For the First Quarter of Fiscal Years | |
|--|--|------------|
| | 2019 | 2018 |
| Net sales | \$89,462 | \$82,763 |
| Cost of goods sold | 71,823 | 66,839 |
| Gross profit | 17,639 | 15,924 |
| Operating expense | | |
| Selling and administrative expenses | 12,370 | 15,205 |
| Internal research and development expenses | 1,349 | 572 |
| Amortization of intangible assets | 1,670 | 1,923 |
| Total operating expense | 15,389 | 17,700 |
| Operating income (loss) | 2,250 | (1,776) |
| Other expense | | |
| Interest expense, net | (1,949) | (1,266) |
| Other, net | (14) | (10) |
| Total other expense, net | (1,963) | (1,276) |
| Income (loss) before income taxes | 287 | (3,052) |
| Income taxes | 75 | (1,068) |
| Net income (loss) | \$212 | \$(1,984) |
| Income (loss) per share of common stock: | | |
| Basic | \$0.02 | \$(0.20) |
| Diluted | 0.02 | (0.20) |
| Weighted average shares of common stock outstanding: | | |
| Basic | 9,834,723 | 9,856,649 |
| Diluted | 9,834,723 | 9,856,649 |

See Notes to unaudited consolidated financial statements.

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

| | For the First Quarter of Fiscal Years | |
|---|---|-----------|
| | 2019 | 2018 |
| Net income (loss) | \$212 | \$(1,984) |
| Other comprehensive income, net: | | |
| Pension amortization of unrecognized net actuarial loss, net of tax | 31 | 35 |
| Other comprehensive income, net | 31 | 35 |
| Comprehensive income (loss) | \$243 | \$(1,949) |

See Notes to unaudited consolidated financial statements.

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SPARTON CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(UNAUDITED)
(Dollars in thousands)

| | For the First Quarter of Fiscal 2019 | | | | | |
|-------------------------------------|--------------------------------------|----------|---------------------------------|----------|--------------------------------|-------------------------|
| | Common Stock | | Capital | Retained | Accumulated | Total |
| | Shares | Amount | In Excess of Par Value | Earnings | Other Comprehensive Loss | Shareholders' Equity |
| Balance at July 1, 2018 | 9,834,723 | \$12,293 | \$17,599 | \$44,713 | \$ (1,001) | \$ 73,604 |
| Stock-based compensation | — | — | (13) | — | — | (13) |
| Adjustment upon adoption of ASC 606 | — | — | — | (345) | — | (345) |
| Net income | | | | 212 | | 212 |
| Comprehensive income, net | — | — | — | — | 31 | 31 |
| Balance at September 30, 2018 | 9,834,723 | \$12,293 | \$17,586 | \$44,580 | \$ (970) | \$ 73,489 |

| | For the First Quarter of Fiscal 2018 | | | | | |
|--|--------------------------------------|----------|---------------------------------|----------|--------------------------------|-------------------------|
| | Common Stock | | Capital | Retained | Accumulated | Total |
| | Shares | Amount | In Excess of Par Value | Earnings | Other Comprehensive Loss | Shareholders' Equity |
| Balance at July 2, 2017 | 9,860,635 | \$12,326 | \$17,851 | \$52,967 | \$ (1,276) | \$ 81,868 |
| Forfeiture of restricted stock (25,912) | (33) | 33 | — | — | — | — |
| Stock-based compensation | — | — | 211 | — | — | 211 |
| Net loss | — | — | — | (1,984) | — | (1,984) |
| Comprehensive income, net | — | — | — | — | 35 | 35 |
| Balance at October 1, 2017 | 9,834,723 | \$12,293 | \$18,095 | \$50,983 | \$ (1,241) | \$ 80,130 |

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 Quarter of Fiscal Years | |
|--|---|-----------|
| | 2019 | 2018 |
| Cash Flows from Operating Activities: | | |
| Net income (loss) | \$212 | \$(1,984) |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: | | |
| Depreciation | 1,410 | 1,536 |
| Amortization of intangible assets | 1,670 | 1,923 |
| Deferred income taxes | 8 | 19 |
| Stock-based compensation expense | (13) |) 211 |
| Amortization of deferred financing costs | 374 | 212 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 6,666 | (8,586) |
| Inventories and cost of contracts in progress | (9,023) | (9,734) |
| Prepaid expenses and other assets | 4,589 | (204) |
| Advance billings on customer contracts | 469 | — |
| Performance based payments on customer contracts | (454) | (1,749) |
| Accounts payable and accrued expenses | 6,321 | (4,873) |
| Net cash provided by (used in) operating activities | 12,229 | (23,229) |
| Cash Flows from Investing Activities: | | |
| Purchases of property, plant and equipment | (651) | (455) |
| Net cash used in investing activity | (651) | (455) |
| Cash Flows from Financing Activities: | | |
| Borrowings under credit facility | 48,100 | 71,700 |
| Repayments under credit facility | (59,600) | (48,600) |
| Payments under capital lease agreements | (68) | (68) |
| Payment of debt financing costs | — | (17) |
| Net cash provided by (used in) financing activities | (11,568) | 23,015 |
| Net increase (decrease) in cash and cash equivalents | 10 | (669) |
| Cash and cash equivalents at beginning of period | 1,160 | 988 |
| Cash and cash equivalents at end of period | \$1,170 | \$319 |
| Supplemental disclosure of cash flow information: | | |
| Cash paid for interest | \$1,505 | \$950 |
| Cash paid for income taxes | 22 | 509 |
| See Notes to unaudited consolidated financial statements. | | |

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SPARTON CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except 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, Management's Discussion and Analysis of Financial Condition and Results of Operations, included in this Quarterly Report on Form 10-Q. Operating results for the quarter ended September 30, 2018 are not necessarily indicative of the results that may be expected for the year ending June 30, 2019. The consolidated balance sheet at July 1, 2018 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States ("GAAP") 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 fiscal year ended July 1, 2018.

The Company reports fiscal years on a 52-53 week year (5-4-4 basis) ending on the Sunday closest to June 30.

Potential Sale of the Company

On July 7, 2017, Sparton Corporation (the "Company" or "Sparton"), Ultra Electronics Holdings plc, ("Ultra"), and Ultra Electronics Aneira Inc., ("Merger Sub") entered into an Agreement and Plan of Merger (the "Merger Agreement") that provided for Ultra to acquire the Company by merging Merger Sub into the Company (such transaction referred to as the "Merger"), subject to the terms and conditions set forth in the Merger Agreement.

On October 5, 2017, at a special meeting of holders of shares of common stock of the Company, shareholders voted to adopt the Merger Agreement. Although the Merger Agreement had been adopted by the Company's shareholders, consummation of the Merger remained subject to other closing conditions, including the expiration or termination of the applicable waiting period (or any extension thereof) under the Hart-Scott-Rodino Antitrust Improvements Act (the "HSR Act").

On March 5, 2018, Sparton announced the termination by Sparton and Ultra of the Merger Agreement as a result of the staff of the United States Department of Justice (the "DOJ") informing the parties that it intended to recommend that the DOJ block the Merger. Under a Merger Termination Agreement entered into by Sparton, Ultra and Merger Sub, the parties agreed to release each other from certain claims and liabilities arising out of or related to the Merger Agreement or the transactions contemplated therein or thereby, including any termination fees. The parties also agreed that certain agreements with confidentiality obligations will continue in full force and effect.

Also on March 5, 2018, Sparton announced that, during the DOJ's review of Sparton's proposed Merger with Ultra, the United States Navy (the "Navy") expressed the view that instead of the parties proceeding with the Merger, each of Sparton and Ultra should enhance its ability to independently develop, produce and sell sonobuoys and over time work toward the elimination of their use of Sparton's and Ultra's joint venture for such activities. Since that time, Sparton has been in communication with the Navy to better understand its expectations with respect to the timing, funding and terms of current and future sonobuoy indefinite delivery / indefinite quantity ("IDIQ") production contracts.

As a result of the termination of the Merger Agreement, the Company announced that it would seek to re-engage with parties that previously expressed an interest in acquiring all or a part of Sparton and that are in a position to expeditiously proceed to effect such a transaction. There can be no assurance that any such process will result in the execution of a definitive agreement or the completion of a transaction.

Q-125A Sonobuoy Bid Process

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On July 9, 2018, the Company announced the filing of a bid protest by ERAPSCO with the United States Government Accountability Office ("GAO") challenging the competitive range exclusion of ERAPSCO under the United States Navy ("Navy") Solicitation No. N00019-19-R-0002 for the GFY 19-23 AN/SSQ-125A (the "Q-125A") production sonobuoy. The protest challenged on a number of bases the Navy's decision to exclude ERAPSCO from the solicitation process and requested that GAO restore ERAPSCO's ability to participate in the process. On August 30, 2018, the Navy issued a notice that it had

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taken corrective action to reopen the competitive range regarding the Q-125A production sonobuoy and include ERAPSCO in that competitive range. This allows ERAPSCO to again participate in the bid process. As a result of the Navy's decision to restore ERAPSCO's ability to participate in the bid process, the GAO dismissed the protest on September 4, 2018.

(2) Revenue Recognition

Effective July 2, 2018, we adopted Accounting Standards Codification 606, "Revenue from Contracts with Customers" ("ASC 606") using the modified retrospective method. As a result, the cumulative effect of adopting ASC 606 on contracts that were open on the date of adoption was recognized as an adjustment to the opening balance sheet at July 2, 2018. We did not restate prior period information in our Balance Sheet, Statement of Operations or Statement of Cash Flows.

Our customers typically engage us to provide distinct products and services. In our Manufacturing and Design Segment, we perform services that include contract design, manufacturing, and aftermarket repair. In our Engineered Components & Products Segment, we provide products and services including design, development and production of proprietary products for domestic and foreign defense markets as well as for commercial needs. We consider contracts to exist once (i) the parties have approved the contract and have committed to perform their respective rights and obligations under the contract, (ii) the commitment of goods or services to be transferred has been established, (iii) the payment terms have been established, (iv) we have determined the contract has commercial substance, and (v) we have determined collectability of substantially all due consideration. We treat contracts with similar characteristics as a portfolio when the results are not materially different from treating contracts individually. The contract price is allocated to each distinct performance obligation and recognized as revenue when, or as, the performance obligation is satisfied.

Performance Obligations

Performance obligations are typically satisfied when or as products are shipped to customers. In certain contracts, transfer of control is recognized prior to shipment if it meets the requirements of a bill-and-hold arrangement or if the contract restricts Sparton's use of the products, thereby eliminating the ability to obtain a benefit from them outside the customer contract. Service based performance obligations are considered satisfied as services are rendered based on costs incurred. The amount of consideration we expect to receive is allocated on the basis of each performance obligation's selling price, including the effect variable consideration to the extent that revenue would likely not be reversed. The primary method used to estimate the standalone selling price is the contracted or list price. Typical payment terms are 30 days from invoicing and, in certain agreements, we receive progress based payments and deposits in advance of our satisfaction of performance obligations. Our warranties are assurance type which are not considered performance obligations and refund or return obligations are not material. The amount of the transaction price allocated to wholly unsatisfied (or partially unsatisfied) performance obligations is represented by our backlog. Of the \$336 million of backlog at September 30, 2018, \$50 million is expected to be recognized as revenue outside the next 12 months.

In our application of practical expedients, under ASC 606, we (i) treat contracts with similar characteristics as a portfolio, (ii) exclude implied financing costs from variable consideration, (iii) record service revenue based on our right to invoice, (iv) expense the incremental cost of obtaining a contract for contracts less than twelve months, (v) exclude taxes collected on behalf of a government authority related to our revenue generating transactions from our calculation of transaction price, and (vi) accrue for expected shipping and handling expenses that are expected to be incurred after control is transferred to customers.

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The net impact of adoption of ASC 606 on the opening balance sheet for the quarter ended September 30, 2018 was as follows:

| | Before Adoption of ASC 606 | Effect of adoption of ASC 606 | After adoption of ASC 606 |
|---|-------------------------------------|--|------------------------------------|
| Assets: | | | |
| Accounts receivable, net of allowance for doubtful accounts | \$ 60,454 | \$(7,777) | \$ 52,677 |
| Inventories and cost of contracts in progress, net | 72,406 | 9,801 | 82,207 |
| Prepaid expenses and other current assets | 3,944 | 7,390 | 11,334 |
| Deferred income taxes | 17,646 | 134 | 17,780 |
| Liabilities: | | | |
| Performance based payments on customer contracts | 3,868 | 9,893 | 13,761 |
| Shareholders' equity: | | | |
| Retained earnings | 44,713 | (345) | 44,368 |

Progress payments from customers related to inventory purchases are reflected as a liability rather than as a reduction of inventory and unbilled accounts receivable are reflected as prepaid and other current assets rather than as accounts receivable. The net impact to retained earnings as a result of adopting ASC 606 was a decrease of \$345.

Contract Assets and Contract Liabilities

Contract assets consist of our right to consideration for work performed or performance obligations completed which have not yet billed. Contract assets are invoiced and considered accounts receivable when the right to consideration no longer has any further contractual conditions. Contract liabilities consist of customer advances or progress payments for which we have not transferred goods or services to our customers. We expect to transfer all underlying goods and services to our customers within 12 months of establishing a contract liability.

Contract assets and contract liabilities from revenue contracts with customers consists of the following as of:

| | For the First Quarter of Fiscal Year 2019 | Beginning of quarter | End of quarter |
|--|--|----------------------------|-------------------|
| Contracts assets: | | | |
| Prepaid expenses and current assets | \$6,891 | \$2,202 | |
| Contracts liabilities: | | | |
| Performance based payments on customer contracts | 13,761 | 13,307 | |
| Advance from customers | 5,899 | 6,368 | |

Revenue of \$13.5 million that was included in the contract liabilities at the beginning of the period was recognized in the quarter ended September 30, 2018. Changes in the contract asset and contract liability account balances were attributed to regular business activity.

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The following tables summarize the impact of adopting ASC 606 on our unaudited condensed consolidated financial statements for the first quarter of fiscal year 2019:

| Condensed Consolidated Balance Sheet | September 30, 2018 | | |
|--|--------------------|-----------------------------------|--------------------------------------|
| | As reported | Net effect of adoption of ASC 606 | Balances without adoption of ASC 606 |
| Assets: | | | |
| Current Assets: | | | |
| Inventories and cost of contracts in progress, net | \$91,230 | \$(1,591) | \$89,639 |
| Total current assets | 149,734 | (1,591) | 148,143 |
| Deferred income taxes | 17,772 | (134) | 17,638 |
| Total assets | \$236,489 | \$(1,725) | \$234,764 |
| Liabilities and Shareholders' Equity: | | | |
| Performance based payments on customer contracts | \$13,307 | \$(3,149) | \$10,158 |
| Other accrued expenses | 10,438 | 227 | 10,665 |
| Total current liabilities | 84,638 | (2,922) | 81,716 |
| Total liabilities | 163,000 | (2,922) | 160,078 |
| Retained earnings | 44,580 | 1,197 | 45,777 |
| Total shareholders' equity | 73,489 | 1,197 | 74,686 |
| Total liabilities and shareholders' equity | \$236,489 | \$(1,725) | \$234,764 |

| Condensed Consolidated Statement of Operations | For the First Quarter of Fiscal Year 2019 | | |
|--|---|-----------------------------------|--------------------------------------|
| | As reported | Net effect of adoption of ASC 606 | Balances without adoption of ASC 606 |
| Net sales | \$89,462 | \$ 1,473 | \$ 90,935 |
| Cost of goods sold | 71,823 | 394 | 72,217 |
| Gross profit | 17,639 | 1,079 | 18,718 |
| Operating income | 2,250 | 1,079 | 3,329 |
| Income before income taxes | 287 | 1,079 | 1,366 |
| Income taxes | 75 | 227 | 302 |
| Net income | \$212 | \$ 852 | \$ 1,064 |

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Revenue by Category

The following table reflects our revenue disaggregated by major end-use market for the periods ended:

| | For the First Quarter of Fiscal Years | |
|----------------------|---|----------|
| | 2019 | 2018 |
| ECP Segment | | |
| U.S. sonobuoy | \$20,843 | \$16,967 |
| Foreign sonobuoy | 3,124 | 5,608 |
| Engineering services | 2,188 | 549 |
| Rugged electronics | 7,157 | 7,268 |
| Total ECP Segment | 33,312 | 30,392 |
| MDS Segment | | |
| Manufacturing | \$51,907 | \$47,692 |
| Engineering services | 3,605 | 4,269 |
| Other | 638 | 410 |
| Total MDS Segment | 56,150 | 52,371 |
| Total net sales | \$89,462 | \$82,763 |

(3) Inventories and Cost of Contracts in Progress, net

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

| | September 30, 2018 | July 1, 2018 |
|--|-----------------------|-----------------|
| Raw materials | \$ 59,482 | \$ 56,088 |
| Work in process | 20,482 | 16,138 |
| Finished goods | 11,266 | 8,784 |
| Total inventory and cost of contracts in progress, gross | 91,230 | 81,010 |
| Inventory to which the U.S. government has title due to interim billings | — | (8,604) |
| Total inventory and cost of contracts in progress, net | \$ 91,230 | \$ 72,406 |

In accordance with the application of ASC 606, progress payments from customers related to inventory purchases are reflected as liabilities rather than as a reduction of net inventories as presented on July 1, 2018.

(4) Property, Plant and Equipment, net

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

| | September 30, 2018 | July 1, 2018 |
|-------------------------------------|-----------------------|-----------------|
| Land and land improvements | \$ 1,439 | \$1,439 |
| Buildings and building improvements | 28,204 | 28,160 |
| Machinery and equipment | 53,390 | 53,250 |
| Construction in progress | 1,851 | 1,391 |
| Total property, plant and equipment | 84,884 | 84,240 |
| Less accumulated depreciation | (52,860) | (51,450) |

Property, plant and equipment, net \$ 32,024 \$32,790

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(5) Other Intangible Assets

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

| | Net Carrying Value at July 1, 2018 | Amortization | Net Carrying Value at September 30, 2018 |
|-----------------------------------|--|--------------|---|
| Non-compete agreements | \$ 680 | \$ (161) | \$ 519 |
| Customer relationships | 19,061 | (1,428) | 17,633 |
| Trademarks/Tradenames | 1,059 | (40) | 1,019 |
| Unpatented technology and patents | 308 | (41) | 267 |
| Other intangible assets, net | \$ 21,108 | \$ (1,670) | \$ 19,438 |

(6) Debt

On September 11, 2014, the Company entered into a revolving line-of-credit facility with a group of banks (the "Credit Facility") which expires on September 11, 2019. On May 3, 2018, the Company entered into Amendment No.5 ("Amendment 5") to the Credit Facility. As a result of Amendment 5, the Company reduced the revolving credit facility from \$125,000 to \$120,000, increased the permitted total funded debt to EBITDA ratio for fiscal quarters ending April 1, 2018 and July 1, 2018 and increased the interest rates to either LIBOR, plus 3.50% to 4.50%, or the bank's base rate, as defined, plus 2.50% to 3.50%.

The facility is secured by substantially all assets of the Company and its subsidiaries. As of September 30, 2018, the Company had \$43,194 available under the facility, reflecting borrowings under the facility of \$73,000, outstanding letters of credit of \$3,706 and capital leases of \$100.

As of September 30, 2018, 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 3.75%, or at the bank's base rate, as defined, plus 0.00% to 2.75%, 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 0.50%, 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 6.90% at September 30, 2018. As a condition of the Credit Facility, the Company is subject to certain customary covenants. The Company was compliant with all such covenants at September 30, 2018.

(7) Income Taxes

On December 22, 2017, the Tax Cuts and Jobs Act of 2017 ("Tax Act") was signed into law. The Tax Act made significant changes to U.S. tax laws including, but not limited to, lowering the federal income tax rate for U.S. corporations from a maximum of 35% to a fixed 21%, revising certain corporate income tax deductions, implementing a territorial tax system and imposing a repatriation tax on unrepatriated earnings of foreign subsidiaries.

For corporations that report on a fiscal year basis, the Tax Act required the use of a full-year blended income tax rate based on the new and old rates. For the first quarter of fiscal year 2018, we used an effective income tax rate of 35% as the Tax Act had not yet been enacted. Subsequent to the Tax Act, the Company used an annual effective income tax rate of 28% for fiscal year 2018, exclusive of any discrete tax events. In the second quarter of fiscal year 2018, the Company recognized the impact of the Tax Act on the first quarter of fiscal year 2018. The Company's estimated annual effective income tax rate for the fiscal year 2019 was determined to be 21%. Income tax expense for the quarter ended September 30, 2018 included a \$15 discrete tax item. 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, as well as the impact of federal, foreign and state tax deductions and credits.

In December 2017, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 118 which addresses how a company recognizes provisional amounts when a company does not have the necessary information

available, prepared or analyzed (including computations) in reasonable detail to complete the accounting for certain tax effects of the Tax Act and provides for a one-year measurement period. The ultimate impact of the Tax Act may differ from the provisional amounts the Company has recorded due to additional analysis, changes in interpretations and assumptions the Company has made and additional regulatory guidance that may be issued. The accounting is expected to be completed at or before the end of the measurement period on December 22, 2018.

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(8) Defined Benefit Pension Plan

The Company has a frozen defined benefit pension plan. The Company recorded net periodic pension expense of \$2 and \$18 for the first quarter of fiscal years 2019 and 2018, respectively. No contributions were made to the pension plan during either of the first quarter of fiscal years 2019 and 2018.

(9) Commitments and Contingencies

The Company is a party to an environmental remediation matter in Albuquerque, New Mexico ("Coors Road"). As of September 30, 2018 and July 1, 2018, Sparton had accrued \$5,347 and \$5,508 respectively, as its estimate of the remaining minimum future discounted financial liability regarding this matter, of which \$642 and \$642, respectively, was classified as a current liability and included on the balance sheets in other accrued expenses. As of September 30, 2018 and July 1, 2018, the Company had accrued \$1,606, in relation to expected reimbursements from the Department of Energy, which are included in other non-current assets on the balance sheets and are considered collectible.

At the end of each fiscal year, the Company is required to certify compliance with Environmental Protection Agency ("EPA") financial assurance requirements. If the Company is not in compliance, funds for environmental remediation costs must be set aside. As a result of the \$9,197 of income tax expense related to the tax law changes from the Tax Act that the Company recorded in fiscal year 2018, the Company was not in compliance with such financial assurance requirements at the end of fiscal year 2018. In October 2018, the Company established the Sparton Corporation Standby Financial Assurance Trust and issued a standby letter of credit in the amount of \$2,512 related to the Coors Rd environmental remediation liability. The trust was established to alternately meet the United States Environmental Protection Agency's financial assurance requirements.

See the Company's Annual Report on Form 10-K for the fiscal year ended July 1, 2018 for further information regarding the Company's environmental matters.

In addition to the foregoing, from time to time, the Company is involved in various legal proceedings relating to claims arising in the ordinary course of business.

The Company and the members of our board of directors were named as defendants in four federal securities class actions purportedly brought on behalf of all holders of the Company's common stock challenging the now terminated proposed Merger with Ultra. The lawsuits generally sought, among other things, to enjoin the defendants from proceeding with the shareholder vote on the Merger Agreement at the special meeting or consummating the Merger unless and until the Company disclosed the allegedly omitted information. The complaints also sought damages allegedly suffered by the plaintiffs as a result of the asserted omissions, as well as related attorneys' fees and expenses. After discussions with counsel for the plaintiffs, the Company included certain additional disclosures in the proxy statement soliciting shareholder approval of the Merger Agreement. The Company believes the demands and complaints were without merit, there were substantial legal and factual defenses to the claims asserted, and the proxy statement disclosed all material information prior to the inclusion of the additional disclosures. The Company made the additional disclosures to avoid the expense and burden of litigation. On September 1, 2017, the court dismissed the lawsuits with prejudice with respect to lead plaintiffs in the lawsuits and without prejudice as to all other shareholders. During the second quarter of fiscal year 2018, the Company and plaintiffs agreed to settle the claim for \$200.

The members of our board of directors were named as defendants in another class action suit filed in the United States District Court for the Northern District of Ohio on October 24, 2017, purportedly brought on behalf of all holders of the Company's common stock. This lawsuit sought damages allegedly suffered by plaintiffs as a result of violations by the members of the board of directors of their fiduciary duties. As a result of the termination of the Merger Agreement, on March 16, 2018, the parties to the lawsuit stipulated to a dismissal of the lawsuit without prejudice. The Company is party to a dispute regarding a health claim by a former employee and her children of one of the Company's former businesses. The plaintiffs sought monetary damages related to their medical care and treatment, pain and suffering, and lost earnings. In fiscal year 2018, the Company accrued \$635 for potential insurance deductibles and legal fees associated with this claim. In August 2018, a \$5,500 settlement was reached between the plaintiffs, the Company, and the Company's insurer, where the Company will pay \$500 in settlement costs in excess of its \$5,000 insurance coverage and \$500 in insurance deductibles. The Company recorded this settlement in fiscal year

2018, and also recorded \$594 of legal fees related to this dispute. The Company expects to pay the settlement in November 2018.

The Company was the plaintiff in a lawsuit against the previous owner and other shareholders of Hunter Technology Corporation (“Hunter”), a business acquired by the Company, for breaches of the acquisition agreement and fraud. In June 2018, the Court ruled against the Company, and the Company was required to reimburse the defendant’s legal fees of \$484. The Company also incurred \$115 of legal fees related to this matter. The Company recorded the liability in the fourth quarter of

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fiscal year 2018, and expensed its related legal fees during 2018. The Company is also involved in a dispute between a predecessor company of Hunter and the California State Board of Equalization (“SBOE”) regarding unpaid taxes for which the Company is liable. In the fourth quarter of fiscal year 2018, the Company accrued \$500 as an estimated settlement of this liability. This dispute remains in negotiations with the SBOE and the Company.

The Company is involved in a matter with Goodrich Corporation (“Goodrich”) in which Goodrich has alleged the Company owes indemnification to Goodrich under an agreement as a result of damages suffered by Goodrich in a lawsuit that Goodrich settled. The Company has disputed the indemnification claim and Goodrich has requested the parties mediate the dispute or move to trial. This dispute is covered by insurance, subject to normal reservation of rights by the insurance company, and the Company believes that a settlement, if any, would likely be within the Company’s coverage. No amounts have been accrued as it is not probable a loss has been incurred.

The Company is not currently a party to any other legal proceedings, the adverse outcome of which, individually or in the aggregate, is expected to have a material adverse effect on our business, financial condition or results of operations.

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 issues of noncompliance that would have a material effect on the Company’s financial position or results of operations.

(10) 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 First Quarter of Fiscal Years | |
|---|--|-------|
| | 2019 | 2018 |
| Fair value expense of stock option awards | \$1 | \$40 |
| Restricted stock units | (14) | 171 |
| Restricted and unrestricted stock | — | — |
| Total stock-based compensation expense | \$(13) | \$211 |

The following is a summary of activity for the first quarter of fiscal year 2019 related to the 2010 Plan:

| | Stock Options | Restricted stock units | Restricted shares |
|-----------------------------------|------------------|------------------------------|----------------------|
| Outstanding at July 1, 2018 | 78,249 | 95,686 | — |
| Granted | — | — | — |
| Forfeited | (7,130) | (21,093) | — |
| Outstanding at September 30, 2018 | 71,119 | 74,593 | — |

As of September 30, 2018, 58,367 stock options were exercisable, of which 16,207 vested in the first quarter of fiscal year 2019.

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(11) Earnings Per Share Data

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

| | For the First Quarter of Fiscal Years | |
|---|---|------------|
| | 2019 | 2018 |
| Numerator: | | |
| Net income (loss) | \$212 | \$(1,984) |
| Less net income allocated to contingently issuable participating securities | — | — |
| Net income (loss) available to common shareholders | \$212 | \$(1,984) |
| Weighted average shares outstanding – Basic | | |
| | 9,834,728 | 8,566,649 |
| Dilutive effect of stock options | — | — |
| Weighted average shares outstanding – Diluted | 9,834,728 | 8,566,649 |
| Net income (loss) available to common shareholders per share: | | |
| Basic | \$0.02 | \$(0.20) |
| Diluted | 0.02 | (0.20) |

Net income available to common shareholders was not reduced by allocated earnings associated with unvested restricted shares of 21,926 for the first quarter of fiscal year 2018, as the unvested restricted shares did not participate in the net loss for the first quarter of fiscal year 2018. There were no unvested restricted stock in first quarter of fiscal year 2019.

The computations of diluted income or loss per share excluded potential shares of common stock issuable upon exercise of stock options totaling 74,803 and 97,640 for the first quarter of fiscal years 2019 and 2018, respectively, as they were anti-dilutive due to option exercise prices in excess of the average share prices for the first quarter of fiscal years 2019 and for 2018, respectively. The computations of diluted income or loss per share also excluded potential shares of common stock issuable upon exercise of restricted stock units totaling 88,539 and 128,134 for the first quarter of fiscal years 2019 and 2018, respectively.

(12) Business Segments

The Company has identified two reportable segments; Manufacturing & Design Services ("MDS") and Engineered Components & Products ("ECP"). 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 assesses segment performance and allocates resources to each segment individually.

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Operating results and certain other financial information about the Company's two reportable segments for the first quarter of fiscal years 2019 and 2018 were as follows:

For the First Quarter of Fiscal Year 2019

| | MDS | ECP | Unallocated | Eliminations | Total |
|--|-----------|----------|-------------|--------------|-----------|
| Gross sales | \$59,294 | \$33,312 | \$ — | \$ (3,144) | \$89,462 |
| Gross profit | 7,209 | 10,430 | — | — | 17,639 |
| Selling and administrative expenses (incl. depreciation) | 5,544 | 3,683 | 3,143 | — | 12,370 |
| Internal research and development expenses | — | 1,349 | — | — | 1,349 |
| Depreciation and amortization | 2,013 | 478 | 589 | — | 3,080 |
| Operating income | 290 | 5,103 | (3,143) | — | 2,250 |
| Capital expenditures | 92 | 284 | 275 | — | 651 |
| Total assets at September 30, 2018 | \$150,719 | \$66,048 | \$ 19,722 | \$ — | \$236,489 |

For the First Quarter of Fiscal Year 2018

| | MDS | ECP | Unallocated | Eliminations | Total |
|--|-----------|----------|-------------|--------------|-----------|
| Gross sales | \$55,308 | \$30,399 | \$ — | \$ (2,944) | \$82,763 |
| Gross profit | 5,993 | 9,931 | — | — | 15,924 |
| Selling and administrative expenses (incl. depreciation) | 5,900 | 3,580 | 5,725 | — | 15,205 |
| Internal research and development expenses | — | 572 | — | — | 572 |
| Depreciation and amortization | 2,327 | 561 | 571 | — | 3,459 |
| Operating income (loss) | (1,485) | 5,434 | (5,725) | — | (1,776) |
| Capital expenditures | 105 | 187 | 163 | — | 455 |
| Total assets at July 1, 2018 | \$147,860 | \$71,558 | \$ 12,584 | \$ — | \$232,002 |

(13) New Accounting Standards

In February 2016, the FASB issued ASU No. 2016-02 ("ASU 2016-02"), Leases (Topic 842). ASU 2016-02 establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for capital leases and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. The Company is currently in the process of evaluating the impact of adoption on its consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13 ("ASU 2016-13"), Financial Instruments—Credit Losses (Topic 326). ASU 2016-13 requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. ASU 2016-13 is effective for fiscal years beginning after December 15, 2019 and early adoption is permitted. The Company is currently in the process of evaluating the impact of adoption on its consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-04 ("ASU 2017-04"), Simplifying the Test for Goodwill Impairment. ASU 2017-04 eliminates step 2 from the goodwill impairment test. As amended, the goodwill impairment test will consist of one step comparing the fair value of a reporting unit with its carrying amount. An entity should recognize a goodwill impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value. An entity may still perform the optional qualitative assessment for a reporting unit to determine if it is more likely than not that goodwill is impaired. ASU 2017-04 will be effective for fiscal years and interim periods beginning after December 15, 2019. ASU 2017-04 is required to be applied prospectively and early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company is currently in the

process of evaluating the impact of adoption on its consolidated financial statements.

In February 2018, the FASB issued ASU 2018-02 (“ASU 2018-02”), Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. ASU 2018-02 permits the reclassification of certain “stranded tax effects” resulting from the recent U.S. tax reform from accumulated other comprehensive income to retained earnings. ASU 2018-02 is effective

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for all entities for fiscal years beginning after December 15, 2018, including interim periods within those years. Entities have the option to record the reclassification either retrospectively to each period in which the income tax effects of tax reform are recognized, or at the beginning of the annual or interim period in which the amendments are adopted. Early adoption is permitted, including adoption in an interim period. The Company is currently in the process of evaluating the impact of adoption on its consolidated financial statements.

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

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. 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.

Consolidated Results of Operations

Presented below is comparative data and discussions regarding our consolidated results of operations for the first quarter of fiscal year 2019 compared to the first quarter of fiscal year 2018. 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.

For the First Quarter of Fiscal Year 2019 compared to the First Quarter of Fiscal Year 2018

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

CONSOLIDATED

| | For the First Quarter of Fiscal Years | | | |
|--|---------------------------------------|------------|------------|------------|
| | 2019 | % of Sales | 2018 | % of Sales |
| Net sales | \$89,462 | 100.0 % | \$82,763 | 100.0 % |
| Cost of goods sold | 71,823 | 80.3 | 66,839 | 80.8 |
| Gross profit | 17,639 | 19.7 | 15,924 | 19.2 |
| Selling and administrative expenses | 12,370 | 13.8 | 15,205 | 18.4 |
| Internal research and development expenses | 1,349 | 1.5 | 572 | 0.7 |
| Amortization of intangible assets | 1,670 | 1.9 | 1,923 | 2.3 |
| Operating income | 2,250 | 2.5 | (1,776) | (2.2) |
| Other expense, net | (1,963) | (2.2) | (1,276) | (1.5) |
| Income (loss) before income taxes | 287 | 0.3 | (3,052) | (3.7) |
| Income taxes (benefit) | 75 | 0.1 | (1,068) | (1.3) |
| Net income (loss) | \$212 | 0.2 % | \$(1,984) | (2.4)% |

The increase in net sales was the result of a \$3.8 million sales increase in our MDS segment due to increasing net volume with existing customers, and a \$2.9 million sales increase in our ECP segment due to increasing revenue for engineering and rugged electronics. The increase in our gross margin was primarily due to improved MDS margins related to lower direct labor and direct service spending and improved margins in rugged electronics due to mix.

Selling and administrative expense was significantly reduced in the first quarter of fiscal year 2019, as compared to first quarter of fiscal year 2018, due to lower advisory and legal expenses of \$1,670 related to the potential sale of the Company as well as other expense reductions of \$1,159. Internal research and development costs increased over the prior year quarter due to investment in technologies for use in undersea warfare.

During the first quarter of fiscal year 2019, the Company recognized a discrete income tax expense of \$15 related to an ongoing state tax audit. Excluding the discrete tax event described above, the Company's estimated annual effective income tax rate for the fiscal years 2019 and 2018 was determined to be approximately 21% and 28%, respectively.

The Company used a 35% effective income tax rate for the first quarter of fiscal year 2018 as it was before the Tax Act was enacted. The difference in rates is due to the impact of the Tax Act.

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Due to the factors described above, the Company reported a net earnings of \$0.2 million, or \$0.02 earnings per share, basic and diluted, for the first quarter of fiscal year 2019, compared to net loss of \$2.0 million, or \$0.20 loss per share, basic and diluted, for the first quarter of fiscal year 2018.

Segment Information

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

MDS

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. Additionally, Sparton is a developer of embedded software and software quality assurance services in connection with medical devices and diagnostic equipment. Customers include OEM and ET customers serving the Medical & Biotechnology, Military & Aerospace and Industrial & Commercial markets. In engineering and manufacturing for its customers, this segment adheres to very strict military and aerospace specifications, Food and Drug Administration guidelines and approvals, in addition to product and process certifications.

ECP

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 anti-submarine warfare ("ASW") devices known as sonobuoys for the U.S. Navy and foreign governments that meet Department of State licensing requirements. This segment also performs an engineering development function for the United States military and prime defense contractors for advanced technologies, ultimately leading to future defense products, as well as replacements for existing products. The sonobuoy product line is built to stringent military specifications. These products are restricted by International Tariff and Arms Regulations and qualified by the U.S. Navy, which limits opportunities for competition. This segment is also a provider of rugged flat panel display systems for military panel PC workstations, air traffic control and industrial and commercial marine applications, as well as high performance industrial grade computer systems and peripherals. Rugged displays are manufactured for prime contractors, in some cases to specific military grade specifications. Additionally, this segment internally develops and markets commercial products for underwater acoustics and microelectromechanical ("MEMS")-based inertial measurement.

MDS

The following table presents selected segment data (dollars in thousands):

| | For the First Quarter of Fiscal Years | | | | |
|-------------------------------------|---------------------------------------|------------|------------|------------|---------|
| | 2019 | % of Sales | 2018 | % of Sales | \$ Chg |
| Gross sales | \$59,294 | 100.0 % | \$55,308 | 100.0 % | \$3,986 |
| Intercompany sales | (3,144) | (5.3) | (2,937) | (5.3) | (207) |
| Net sales | 56,150 | 94.7 | 52,371 | 94.7 | 3,779 |
| Gross profit | 7,209 | 12.2 | 5,993 | 10.8 | 1,216 |
| Selling and administrative expenses | 5,544 | 9.4 | 5,900 | 10.7 | (356) |
| Amortization of intangible assets | 1,375 | 2.3 | 1,578 | 2.8 | (203) |
| Operating income (loss) | \$290 | 0.5 % | \$(1,485) | (2.7)% | \$1,775 |

The \$3.8 million increase in net sales was due to net volume increases with existing customers. MDS backlog was \$156.3 million at the end of the first quarter of fiscal year 2019 compared to \$130.5 million at the end of the first quarter of fiscal year 2018. 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 September 30, 2018 MDS backlog is currently expected to be realized in the next 12 months.

Gross margin increased primarily due to lower labor and direct service spending. The decrease in selling and administrative expense was due to cost mitigation and lower corporate allocations.

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ECP

The following table presents selected segment data (dollars in thousands):

| | For the First Quarter of Fiscal Years | | | | |
|--|---------------------------------------|------------|----------|------------|----------|
| | 2019 | % of Sales | 2018 | % of Sales | \$ Chg |
| Gross sales | \$33,312 | 100.0% | \$30,399 | 100.0 % | \$2,913 |
| Intercompany sales | — | — | (7) | — | 7 |
| Net sales | 33,312 | 100.0 | 30,392 | 100.0 | 2,920 |
| Gross profit | 10,430 | 31.3 | 9,931 | 32.7 | 499 |
| Selling and administrative expenses | 3,683 | 11.1 | 3,580 | 11.8 | 103 |
| Internal research and development expenses | 1,349 | 4.0 | 572 | 1.9 | 777 |
| Amortization of intangible assets | 295 | 0.9 | 345 | 1.1 | (50) |
| Operating income | \$5,103 | 15.3 % | \$5,434 | 17.9 % | \$(331) |

The \$2.9 million increase in net sales was due to (i) a \$3.9 million increase in domestic sonobuoy sales, (ii) increased engineering sales of \$1.6 million, offset by (i) a \$2.5 million decrease in foreign sonobuoy sales and (ii) a \$0.1 million decrease in rugged electronics sales and other revenue streams. Total sales to the U.S. Navy in the first quarter of fiscal years 2019 and 2018 were \$23.0 million and \$17.5 million, respectively. For the first quarter of fiscal years 2019 and 2018, sales to the U.S. Navy accounted for 26% and 21%, respectively, of consolidated Company net sales and 69% and 58%, respectively, of ECP segment net sales. ECP backlog was \$180.2 million at the end of the first quarter of fiscal year 2019 compared to \$141.9 million at the end of the first quarter of fiscal year 2018. Substantially all of the September 30, 2018 ECP backlog is currently expected to be realized in the next 18 months.

Gross margin percentage declined from prior year due to mix. Gross margin increased from prior year due to volume. Selling and administrative expense remained consistent.

Internal research and development expenses reflect costs incurred for the internal development of technologies for use in undersea warfare, navigation, hand-held targeting applications as well as rugged electronics and display devices.

These costs include salaries and related expenses, contract labor and consulting costs, materials and the cost of certain research and development specific equipment. In the first quarter of fiscal year 2019, ECP increased internal research and development spending, primarily toward technologies in undersea warfare, by \$0.8 million as compared to the same period in fiscal year 2018.

Eliminations and Corporate Unallocated

The following table presents selected data (dollars in thousands):

| | For the First Quarter of Fiscal Years | | |
|---|---------------------------------------|-----------|---------|
| | 2019 | 2018 | \$ Chg |
| Intercompany sales elimination | \$(3,144) | \$(2,944) | \$(200) |
| Selling and administrative expenses unallocated | 3,143 | 5,725 | (2,582) |

Total corporate selling and administrative expenses before allocation to operating segments were \$6.4 million and \$9.2 million for the first quarter of fiscal year 2019 and fiscal year 2018, respectively, or 7.2% and 11.1% of consolidated sales, respectively. Of these costs, \$3.3 million and \$3.4 million, respectively, were allocated to segment operations in each of these periods. The decrease in corporate selling and administrative expenses was due to lower advisory and legal expenses related to the potential sale of the Company as well as other expense reductions.

Liquidity and Capital Resources

As of September 30, 2018, the Company had \$43.2 million available under its \$120.0 million credit facility, reflecting borrowings under the facility of \$73.0 million, outstanding letters of credit of \$3.7 million and capital leases of \$0.1 million.

On May 3, 2018, the Company entered into Amendment No.5 ("Amendment 5") to the Credit Facility. As a result of Amendment 5, the Company reduced the revolving credit facility from \$125.0 million to \$120.0 million, increased the permitted total funded debt to EBITDA ratio for fiscal quarters ending April 1, 2018 and July 1, 2018 and increased

the interest rates to either LIBOR, plus 3.50% to 4.50%, or the bank's base rate, as defined, plus 2.50% to 3.50%.

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Amendment 5 increased the permitted total funded debt to EBITDA ratio to 4.5x for fiscal quarters ending April 1, 2018 and July 1, 2018. Beginning with the fiscal quarter ended September 30, 2018 and thereafter, the funded debt to EBITDA ratio covenant was 3.0x. The Company was in compliance with all covenants at September 30, 2018. The credit facility expires September 11, 2019 and the Company believes that it will be able to restructure its long-term debt in order to provide for sufficient liquidity for its anticipated needs for the next 12 months.

| | For the First Quarter of Fiscal Years | |
|--|---|----------|
| | 2019 | 2018 |
| CASH FLOWS | | |
| Operating activities, excluding net changes in working capital | \$3,661 | \$1,917 |
| Net changes in working capital | 8,568 | (25,146) |
| Operating activities | 12,229 | (23,229) |
| Investing activities | (651) | (455) |
| Financing activities | (11,568) | 23,015 |

Net changes in working capital related cash flows in the first quarter of fiscal year 2019 primarily reflect decreased accounts receivables, increased performance based payments on customer contracts and accounts payable and accrued expenses, which were partially offset by increased inventories and prepaid expenses and other assets. Working capital related cash flows in the first quarter of fiscal year 2018 primarily reflect increased accounts receivables and inventories, and decreased accounts payable and accrued expenses.

Net cash used in investing activity for the first quarter of fiscal year 2019 and 2018 reflect net capital expenditures of \$0.7 million and \$0.5 million, respectively.

Net cash provided by financing activities in the first quarter of fiscal year 2019 reflects \$11.5 million of net repayments under the Company's Credit Facility as compared to \$23.1 million in net borrowings for the first quarter of fiscal year 2018.

Commitments and Contingencies

See Note 9, 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 July 1, 2018. As of July 1, 2018, there were \$51.0 million of non-cancelable purchase orders outstanding, \$84.5 million of debt, \$12.3 million of operating lease payments and a liability related to performance based billings was \$3.9 million. As of September 30, 2018, compared to July 1, 2018, the non-cancelable purchase orders outstanding increased to \$64.2 million, debt decreased to \$73.0 million, operating lease payments, net of subleases, remained at \$12.3 million and a liability related to performance based billings increased to \$13.3 million. Other than as noted above, there have been no material changes in the nature or amount of the Company's contractual obligations since the end of fiscal year 2018.

Off-Balance Sheet Arrangements

The Company has standby letters of credit outstanding of \$3.7 million at September 30, 2018, principally to support foreign sonobuoy sales and 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

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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
- Goodwill and other intangible assets
- Environmental contingencies
- Income taxes
- Commercial inventory valuation
- Stock-based compensation

Aside from changes previously disclosed in Note 13, New Accounting Standards, of the “Notes to Unaudited Consolidated Financial Statements,” there have been no significant changes to our critical accounting policies 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 fiscal year ended July 1, 2018.

New Accounting Pronouncements

See Note 13, 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.

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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 \$73.0 million outstanding under its Credit Facility at September 30, 2018. 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 \$0.7 million in our annual interest expense. The Company is not party to any currency exchange or interest rate protection agreements as of September 30, 2018.

Item 4. Controls and Procedures.

Our Interim 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 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.

Remediation of prior year material weaknesses

We previously identified and disclosed in our Form 10-K for the year ended July 1, 2018, a material weaknesses in our internal control over financial reporting as we did not maintain effective controls related to the use of our consolidation and financial reporting tool in our interim reporting periods within the above year.

As part of our financial statement close process for fiscal year 2018 and for the first three months of fiscal 2019, we implemented changes to our processes to improve our controls over financial reporting. Among the changes implemented as a result of the identified material weakness, we no longer allow adjustments to be made in our consolidation and financial reporting tool (other than reclassification entries for reporting purposes) that are not also reflected in the ERP systems of the operating entities and we have increased our oversight of the consolidation and reporting tool. Based on the remediation performed by us, we have concluded that the material weakness described above and first disclosed in our Annual Report on Form 10-K for the year ended July 1, 2018 has been remediated as of September 30, 2018.

Changes in Internal Control over Financial Reporting

In addition to the changes described above to remediate the previously identified material weakness, we adopted ASC 606, "Revenue from Contracts with Customers" ("ASC 606"), as of July 2, 2018, and as a result, there was an impact to our internal control over financial reporting. The majority of our ECP revenue changed from being recognized on a percentage of completion based on units shipped methodology to a point in time upon shipment methodology. We implemented changes to our processes related to revenue recognition and control activities within them. These changes included the development of new and revised processes based on the five-step model provided in ASC 606, and the revision of processes for ongoing contract review requirements, development and monitoring of contract estimates, and gathering of disclosure information.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

See Note 9, 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 July 1, 2018 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
Description
Number

| | |
|-------|--|
| 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. |
| 3.3 | Amendment to Amended and Restated Code of Regulations of the Registrant, incorporated by reference from Exhibit 99.1 to the Registrant's Current Report on Form 8-K filed with the SEC on June 15, 2017. |
| 10.1 | Merger Termination Agreement dated as of March 4, 2018 by and among Sparton Corporation, Ultra Electronics Holdings plc, and Ultra Electronics Aneira Inc., incorporated herein by reference from Exhibit 10.1 to the Registrant's Current Report on Form 8-K filed with the SEC on March 5, 2018. |
| 31 | Interim Chief Executive Officer certification under Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31 | Chief Financial Officer certification under Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1* | Interim 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. |
| XBRS | Instance Document |
| XBRCF | Taxonomy Extension Schema Document |
| XBRAI | Taxonomy Calculation Linkbase Document |
| XBREF | Taxonomy Extension Definition Linkbase Document |
| XBRL | Taxonomy Extension Label Linkbase Document |
| 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: November 8, 2018 By: /s/ JOSEPH J. HARTNETT

Joseph J. Hartnett

Interim President and Chief Executive Officer

(Principal Executive Officer)

Date: November 8, 2018 By: /s/ JOSEPH G. MCCORMACK

Joseph G. McCormack

Senior Vice President and Chief Financial Officer

(Principal Financial Officer)