SPARTON CORP
Form 10-Q
May 09, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended April 1, 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 incorporation or organization) | (I.R.S. Employer Identification No.) |
| 425 N. Martingale Road, Suite 1000, Schaumburg, Illinois | 60173-2213 |
| (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 ý 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 ý 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 ý |
| Non-accelerated filer ¨ (Do not check if a smaller reporting company) | Smaller reporting company ¨ |
| | Emerging growth company o |

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. o

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

As of May 4, 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 th 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)

| | April 1, 2018 (Unaudited) | July 2, 2017 |
|---|---|---|
| Assets | | |
| Current Assets: | | |
| Cash and cash equivalents | $ 792 | $ 988 |
| Accounts receivable, net of allowance for doubtful accounts of $374 and $407, respectively | 65,730 | 45,347 |
| Inventories and cost of contracts in progress, net | 65,448 | 60,248 |
| Prepaid expenses and other current assets | 3,639 | 3,851 |
| Total current assets | 135,609 | 110,434 |
| Property, plant and equipment, net | 33,760 | 34,455 |
| Goodwill | 12,663 | 12,663 |
| Other intangible assets, net | 22,827 | 28,445 |
| Deferred income taxes | 14,760 | 24,893 |
| Other non-current assets | 4,988 | 6,253 |
| Total assets | $ 224,607 | $ 217,143 |
| Liabilities and Shareholders' Equity | | |
| Current Liabilities: | | |
| Accounts payable | $ 28,401 | $ 27,672 |
| Accrued salaries | 9,662 | 11,453 |
| Accrued health benefits | 1,207 | 1,150 |
| Performance based payments on customer contracts | — | 1,749 |
| Current portion of capital lease obligations | 218 | 269 |
| Other accrued expenses | 11,512 | 11,959 |
| Total current liabilities | 51,000 | 54,252 |
| Credit facility | 96,800 | 74,500 |
| Capital lease obligations, less current portion | 17 | 167 |
| Environmental remediation | 5,092 | 5,468 |
| Pension liability | 787 | 888 |
| Total liabilities | 153,696 | 135,275 |
| 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 9,860,635 shares issued and outstanding, respectively | 12,293 | 12,326 |
| Capital in excess of par value | 18,112 | 17,851 |
| Retained earnings | 41,696 | 52,967 |
| Accumulated other comprehensive loss | (1,190) | (1,276) |
| Total shareholders' equity | 70,911 | 81,868 |
| Total liabilities and shareholders' equity | $ 224,607 | $ 217,143 |

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 Third Quarter of Fiscal Years | | For the First Three Quarters of Fiscal Years | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| Net sales | $93,938 | $95,410 | $274,520 | $293,176 |
| Cost of goods sold | 76,262 | 78,495 | 221,827 | 243,078 |
| Gross profit | 17,676 | 16,915 | 52,693 | 50,098 |
| Operating expense: | | | | |
| Selling and administrative expenses | 13,253 | 12,862 | 42,532 | 39,198 |
| Internal research and development expenses | 307 | 424 | 1,548 | 1,308 |
| Amortization of intangible assets | 1,802 | 2,099 | 5,618 | 6,509 |
| Total operating expense | 15,362 | 15,385 | 49,698 | 47,015 |
| Operating income | 2,314 | 1,530 | 2,995 | 3,083 |
| Other income (expense) | | | | |
| Interest expense, net | (1,460) | (1,075) | (4,233) | (3,327) |
| Other, net | — | 20 | 3 | 29 |
| Total other expense, net | (1,460) | (1,055) | (4,230) | (3,298) |
| Income (loss) before income taxes | 854 | 475 | (1,235) | (215) |
| Income taxes | 239 | 46 | 10,036 | 155 |
| Net income (loss) | $615 | $429 | $(11,271) | $(370) |
| Income (loss) per share of common stock: | | | | |
| Basic | $0.06 | $0.04 | $(1.15) | $(0.04) |
| Diluted | $0.06 | $0.04 | $(1.15) | $(0.04) |
| Weighted average shares of common stock outstanding: | | | | |
| Basic | 9,834,723 | 9,818,789 | 9,834,723 | 9,804,908 |
| Diluted | 9,834,723 | 9,818,789 | 9,834,723 | 9,804,908 |

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 Third Quarter of Fiscal Years | | For the First Three Quarters of Fiscal Years | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| Net income (loss) | $615 | $429 | $(11,271) | $(370) |
| Other comprehensive income, net: | | | | |
| Pension amortization of unrecognized net actuarial loss, net of tax | 29 | 55 | 86 | 145 |
| Other comprehensive income, net | 29 | 55 | 86 | 145 |
| Comprehensive income (loss) | $644 | $484 | $(11,185) | $(225) |

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 Three Quarters of Fiscal Years | |
|---|---|---|
| | 2018 | 2017 |
| Cash Flows from Operating Activities: | | |
| Net loss | $(11,271) | $(370) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: | | |
| Depreciation | 4,428 | 4,474 |
| Amortization of intangible assets | 5,618 | 6,509 |
| Deferred income taxes | 10,133 | 32 |
| Stock-based compensation expense | 229 | 825 |
| Amortization of deferred financing costs | 810 | 373 |
| Loss (gain) on sale of property, plant and equipment, net | 23 | (13) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (20,383) | (1,333) |
| Inventories and cost of contracts in progress | (5,200) | 12,905 |
| Prepaid expenses and other assets | 855 | 1,440 |
| Performance based payments on customer contracts | (1,749) | — |
| Accounts payable and accrued expenses | (1,843) | (9,336) |
| Net cash provided by (used in) operating activities | (18,350) | 15,506 |
| Cash Flows from Investing Activities: | | |
| Purchases of property, plant and equipment | (3,779) | (4,829) |
| Proceeds from sale of property, plant and equipment | 23 | 17 |
| Net cash used in investing activity | (3,756) | (4,812) |
| Cash Flows from Financing Activities: | | |
| Borrowings under credit facility | 166,900 | 101,163 |
| Repayments under credit facility | (144,600) | (110,747) |
| Payments under capital lease agreements | (201) | (195) |
| Payment of debt financing costs | (189) | (15) |
| Net cash provided by (used in) financing activities | 21,910 | (9,794) |
| Net increase (decrease) in cash and cash equivalents | (196) | 900 |
| Cash and cash equivalents at beginning of period | 988 | 132 |
| Cash and cash equivalents at end of period | $792 | $1,032 |
| Supplemental disclosure of cash flow information: | | |
| Cash paid for interest | $3,255 | $2,532 |
| Cash paid for income taxes | 675 | 553 |
| Supplemental disclosure of non-cash investing activities: | | |
| Machinery and equipment financed under capital leases | — | 148 |

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 and three quarters ended April 1, 2018 are not necessarily indicative of the results that may be expected for the year ending July 1, 2018. The consolidated balance sheet at July 2, 2017 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 2, 2017.
The Company reports fiscal years on a 52-53 week year (5-4-4 basis) ending on the Sunday closest to June 30.
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 IDIQ production contracts. While no deadlines have been established nor funding decisions agreed upon, we believe the Navy would find it desirable if Sparton and Ultra were in a position to eliminate the use of the ERAPSCO joint venture for the sale of sonobuoys to the Navy by September, 2024, which is the end of the GFY19-GFY23 IDIQ contract. Due to the significance of the effort and expenditures required, there can be no assurance that Sparton, or both of the ERAPSCO joint venture partners, will be able to independently develop, produce and sell fully qualified sonobuoys by that time, or at an earlier date if so required by the Navy. The GFY19-GFY23 IDIQ contract is currently under evaluation and we anticipate that an award will be made by the Navy in GFY19 and that final delivery will be scheduled to occur in 2024. Additionally, we understand

that there will be no impact on the existing GFY14-GFY18 IDIQ contract which provides for final delivery to occur in 2019.

As a result of the termination of the Merger Agreement, the Company announced that it will 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. The Company is currently in active discussions with interested parties. There can be no assurance these discussions will result in the execution of a definitive agreement or the completion of a transaction.

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

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

| | April 1, 2018 | July 2, 2017 |
|---|---|---|
| Raw materials | $56,398 | $31,353 |
| Work in process | 18,146 | 19,098 |
| Finished goods | 5,023 | 18,338 |
| Total inventory and cost of contracts in progress, gross | 79,567 | 68,789 |
| Inventory to which the U.S. government has title due to interim billings | (14,119) | (8,541) |
| Total inventory and cost of contracts in progress, net | $65,448 | $60,248 |

(3) Property, Plant and Equipment, net

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

| | April 1, 2018 | July 2, 2017 |
|---|---|---|
| Land and land improvements | $1,439 | $1,439 |
| Buildings and building improvements | 28,082 | 28,121 |
| Machinery and equipment | 51,968 | 46,502 |
| Construction in progress | 2,487 | 4,463 |
| Total property, plant and equipment | 83,976 | 80,525 |
| Less accumulated depreciation | (50,216) | (46,070) |
| Total property, plant and equipment, net | $33,760 | $34,455 |

(4) Other Intangible Assets

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

| | Net Carrying Value at July 2, 2017 | Amortization | Net Carrying Value at April 1, 2018 |
|---|---|---|---|
| Non-compete agreements | $ 1,345 | $ (505) | $ 840 |
| Customer relationships | 25,377 | (4,841) | 20,536 |
| Trademarks/Tradenames | 1,221 | (121) | 1,100 |
| Unpatented technology and patents | 502 | (151) | 351 |
| | $ 28,445 | $ (5,618) | $ 22,827 |

(5) Debt

On September 11, 2014, the Company entered into a revolving line-of-credit facility with a group of banks (the “Credit Facility”). The Company amended the Credit Facility on April 13, 2015, June 27, 2016 and again on June 30, 2017. As of April 1, 2018, the Credit Agreement permitted the Company to borrow up to $125,000. The facility is secured by substantially all assets of the Company and its subsidiaries and expires on September 11, 2019. As of April 1, 2018, the Company had $24,035 available under the facility, reflecting borrowings under the facility of $96,800, outstanding letters of credit of $3,930 and capital leases of $235.

As of April 1, 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 4.53% at April 1, 2018.

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

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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%.
As a condition of the Credit Facility, the Company is subject to certain customary covenants, which had been met or waived at April 1, 2018.

(6) 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.
The new tax rate is effective January 1, 2018. For corporations that report on a fiscal year basis, the Tax Act requires the use of a full-year blended income tax rate based on the new and old rates. Based on a federal rate of 35% for the first two quarters of fiscal year 2018 and 21% for the second two quarters of fiscal year 2018, as well as other factors discussed below, the Company estimated its annual effective income tax rate for fiscal year 2018 will be approximately 28%, exclusive of any discrete tax events. During the second quarter of fiscal year 2018, as a result of the Tax Act, the Company recorded income tax expense of $10,100 for a provisional reduction in its net deferred tax assets and $400 for a provisional liability related to unrepatriated earnings and profits of foreign subsidiaries.
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 near the end of calendar year 2018, as the tax return for fiscal year 2018 is being finalized.
During the second quarter of fiscal year 2018, the Company recognized the impacts of the Tax Act as discrete income tax events. Additionally, the Company recognized a discrete income tax benefit of $118 during the second quarter of fiscal year 2018 as a result of the filing of the fiscal year 2017 tax return as well as amending certain tax returns from earlier tax years. The Company recognized a discrete income tax benefit of $121 during the third quarter of fiscal year 2017 related to the conclusion of a state tax audit and a discrete income tax expense of $350 in the second quarter of fiscal year 2017 related to its Vietnam subsidiary.
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. Excluding the discrete tax events described above, the Company's estimated annual effective income tax rate for the fiscal years 2018 and 2017 was determined to be approximately 28% and 35%, respectively.

(7) Defined Benefit Pension Plan

The Company has a frozen defined benefit pension plan. The Company recorded net periodic pension expense of $6 and $18 for the third quarter of fiscal years 2018 and 2017, respectively. Net periodic pension expense was $19 and $55 for the first three quarters of fiscal years 2018 and 2017, respectively. No contributions were made to the pension plan during either of the first three quarters of fiscal years 2018 and 2017.

(8) Commitments and Contingencies

The Company is a party to an environmental remediation matter in Albuquerque, New Mexico ("Coors Road"). As of April 1, 2018 and July 2, 2017, Sparton had accrued $5,659 and $6,036 respectively, as its estimate of the remaining minimum future discounted financial liability regarding this matter, of which $567 and $568, respectively, was classified as a current liability and included on the balance sheets in other accrued expenses. As of April 1, 2018 and July 2, 2017, 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.

On October 3, 2016, the Company established the Sparton Corporation Standby Financial Assurance Trust and issued a standby letter of credit in the amount of $3,114 related to the Coors Road environmental remediation liability. The trust was established to meet the United States Environmental Protection Agency’s financial assurance requirements. As a result of the

goodwill write-off of $64,174 in fiscal year 2016, the Company was not in compliance with these requirements as of the end of fiscal year 2016. As of the end of fiscal year 2017, the Company was again in compliance with these requirements and during the second quarter of fiscal year 2018, the Company dissolved the trust and canceled the letter of credit.

See the Company's Annual Report on Form 10-K for the fiscal year ended July 2, 2017 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 on the amount of attorneys' fees, and $200 was paid to plaintiffs' counsel.

In addition, 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 seeks 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 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. The Company is also a party to a dispute regarding a health claim by a former employee of one of the Company's former businesses and her children. The plaintiffs are seeking money damages related to their medical care and treatment, pain and suffering, and lost earnings. The lawsuit was filed in the First Judicial District Court for the County of Santa Fe in August 2016. The Company has insurance covering this matter, subject to normal reservation of rights by the insurance company, and believes that a settlement, if any, would likely be within the Company's coverage. During the third quarter of fiscal 2018, the Company accrued $635 for potential insurance deductibles and legal fees associated with this claim.

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.

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(9) 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 Third Quarter of Fiscal Years | | For the First Three Quarters of Fiscal Years | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| Fair value expense of stock option awards | $5 | $48 | $49 | $145 |
| Restricted stock units | 2 | 447 | 180 | 1,251 |
| Restricted and unrestricted stock | — | (947) | — | (571) |
| Total stock-based compensation expense | $7 | $(452) | $229 | $825 |

The following is a summary of activity for the first three quarters of fiscal year 2018 related to the 2010 Plan:

| | Stock Options | Restricted stock units | Restricted shares |
|---|---|---|---|
| Outstanding at July 2, 2017 | 100,022 | 128,134 | 25,912 |
| Granted | — | — | — |
| Forfeited | (12,647) | (19,632) | (25,912) |
| Outstanding at April 1, 2018 | 87,375 | 108,502 | — |

As of April 1, 2018, 51,288 stock options were exercisable, of which 23,138 vested in the first two quarters of fiscal year 2018. No stock options vested during the third quarter of fiscal year 2018.

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(10) Earnings Per Share Data

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

| | For the Third Quarter of Fiscal Years | | For the First Three Quarters of Fiscal Years | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| Numerator: | | | | |
| Net income (loss) | $615 | $ 429 | $(11,271) | $ (370 ) |
| Less net income allocated to contingently issuable participating securities | — | — | — | — |
| Net income (loss) available to common shareholders | $615 | $ 429 | $(11,271) | $ (370 ) |
| Weighted average shares outstanding – Basic | 9,834,723 | 9,818,789 | 9,834,723 | 9,804,908 |
| Dilutive effect of stock options | — | — | — | — |
| Weighted average shares outstanding – Diluted | 9,834,723 | 9,818,789 | 9,834,723 | 9,804,908 |
| Net income (loss) available to common shareholders per share: | | | | |
| Basic | $0.06 | $ 0.04 | $(1.15 ) | $ (0.04 ) |
| Diluted | $0.06 | $ 0.04 | $(1.15 ) | $ (0.04 ) |

Net income available to common shareholders was not reduced by allocated earnings associated with unvested restricted shares of 7,309 and 31,518 for the first three quarters of fiscal years 2018 and 2017, respectively, as the unvested restricted shares did not participate in the net losses for these periods and 25,912 for the third quarter of fiscal year 2017, as the impact was not material. There were no restricted shares outstanding during the third quarter of fiscal year 2018.

The computations of diluted income or loss per share excluded potential shares of common stock issuable upon exercise of stock options totaling 92,605 and 102,247 for the third quarters of fiscal years 2018 and 2017, respectively, as they were anti-dilutive due to option exercise prices in excess of the average share prices and totaling 95,639 and 105,726 for the first three quarters of fiscal years 2018 and 2017, respectively, as they were anti-dilutive due to the net losses for these periods. The computations of diluted income or loss per share also excluded potential shares of common stock issuable upon exercise of restricted stock units totaling 117,242 and 144,068 for the third quarters of fiscal years 2018 and 2017, respectively, and 123,324 and 134,123 for the first three quarters of fiscal years 2018 and 2017, respectively, as the shares were contingently issuable.

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(11) 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.

Operating results and certain other financial information about the Company's two reportable segments for the third quarter and first three quarters of fiscal years 2018 and 2017 were as follows:

| | For the Third Quarter of Fiscal Year 2018 | | | | |
|---|---|---|---|---|---|
| | MDS | ECP | Unallocated | Eliminations | Total |
| Net sales | $59,786 | $37,199 | $ — | $ (3,047 ) | $93,938 |
| Gross profit | 7,164 | 10,512 | — | — | 17,676 |
| Selling and administrative expenses (incl. depreciation) | 5,487 | 3,454 | 4,312 | — | 13,253 |
| Internal research and development expenses | — | 307 | — | — | 307 |
| Depreciation and amortization | 2,149 | 517 | 574 | — | 3,240 |
| Operating income (loss) | 204 | 6,422 | (4,312 ) | — | 2,314 |
| Capital expenditures | 384 | 121 | 175 | — | 680 |
| Total assets at April 1, 2018 | $146,739 | $76,610 | $ 1,258 | $ — | $224,607 |

| | For the Third Quarter of Fiscal Year 2017 | | | | |
|---|---|---|---|---|---|
| | MDS | ECP | Unallocated | Eliminations | Total |
| Net sales | $61,084 | $37,053 | $ — | $ (2,727 ) | $95,410 |
| Gross profit | 6,690 | 10,225 | — | — | 16,915 |
| Selling and administrative expenses (incl. depreciation) | 5,684 | 4,160 | 3,018 | — | 12,862 |
| Internal research and development expenses | — | 424 | — | — | 424 |
| Depreciation and amortization | 2,577 | 563 | 444 | — | 3,584 |
| Operating income (loss) | (722 ) | 5,270 | (3,018 ) | — | 1,530 |
| Capital expenditures | 1,291 | 260 | 708 | — | 2,259 |
| Total assets at July 2, 2017 | $142,513 | $64,694 | $ 9,936 | $ — | $217,143 |

| | For the First Three Quarters of Fiscal Year 2018 | | | | |
|---|---|---|---|---|---|
| | MDS | ECP | Unallocated | Eliminations | Total |
| Net sales | $173,447 | $110,065 | $ — | $ (8,992 ) | $274,520 |
| Gross profit | 20,116 | 32,577 | — | — | 52,693 |
| Selling and administrative expenses (incl. depreciation) | 17,001 | 10,604 | 14,927 | — | 42,532 |
| Internal research and development expenses | — | 1,548 | — | — | 1,548 |
| Depreciation and amortization | 6,724 | 1,613 | 1,709 | — | 10,046 |
| Operating income (loss) | (1,489 ) | 19,411 | (14,927 ) | — | 2,995 |
| Capital expenditures | $2,699 | $516 | $ 564 | $ — | $3,779 |

| | For the First Three Quarters of Fiscal Year 2017 | | | | |
|---|---|---|---|---|---|
| | MDS | ECP | Unallocated | Eliminations | Total |
| Net sales | $193,468 | $106,995 | $ — | $ (7,287 ) | $293,176 |
| Gross profit | 22,341 | 27,757 | — | — | 50,098 |

| | | | | | |
|---|---|---|---|---|---|
| Selling and administrative expenses (incl. depreciation) | 17,221 | 11,529 | 10,448 | — | 39,198 |
| Internal research and development expenses | — | 1,308 | — | — | 1,308 |
| Depreciation and amortization | 7,901 | 1,755 | 1,327 | — | 10,983 |
| Operating income (loss) | (250) | 13,781 | (10,448) | — | 3,083 |
| Capital expenditures | $1,960 | $1,018 | $ 1,851 | $ — | $4,829 |

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(12) New Accounting Standards

In May 2014, the Financial Accounting Standards ("FASB") issued Accounting Standards Update ("ASU") 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. In August 2015, the FASB issued an amendment to defer the effective date for all entities by one year. The new standard will become effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Early adoption is permitted as of annual reporting periods beginning after December 15, 2016. Companies have the option of using either a full or modified retrospective approach in applying this standard. During fiscal years 2016 and 2017, the FASB issued four additional updates which further clarify the guidance provided in ASU 2014-09. The Company has identified key personnel to evaluate the guidance and approve a transition method, while also formulating a time line to review the potential impact of the new standard on its existing revenue recognition policies and procedures. The Company has identified significant contracts with customers and the promised goods and/or services associated with the revenue streams for each segment. The Company is evaluating the distinct performance obligations and the pattern of revenue recognition of these significant contracts in advance of the implementation of the standard. It is also determining the impact of adopting the standard on its control framework and may require changes to its systems and other controls process.

In July 2015, the FASB issued ASU 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. There was no significant impact on the Company's financial statements as a result of the adoption in the first quarter of fiscal year 2018.

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 August 2016, the FASB issued ASU No. 2016-15 ("ASU 2016-15"), Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments. ASU 2016-15 will make eight targeted changes to how cash receipts and cash payments are presented and classified in the statement of cash flows. ASU 2016-15 is effective for fiscal years beginning after December 15, 2017. The new standard will require adoption on a retrospective basis unless it is impracticable to apply, in which case it would be required to apply the amendments prospectively as of the earliest date practicable. The Company is currently in the process of evaluating the impact of adoption on its consolidated financial statements.

In October 2016, the FASB issued ASU 2016-16 ("ASU 2016-16"), Income Taxes - Intra-Entity Transfers of Assets Other Than Inventory, which requires entities to recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. ASU 2016-16 is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted as of the beginning of a fiscal year. ASU 2016-16 must be adopted using a modified retrospective transition method which is a cumulative-effective adjustment to retained earnings as of the beginning of the first effective reporting period. The Company is currently in the process of evaluating the impact of adoption on its consolidated financial statements.

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In November 2016, the FASB issued ASU No. 2016-18 ("ASU 2016-18"), Restricted Cash, which addresses classification and presentation of changes in restricted cash on the statement of cash flows. ASU 2016-18 requires an entity's reconciliation of the beginning-of-period and end-of-period total amounts shown on the statement of cash flows to include in cash and cash equivalents amounts generally described as restricted cash and restricted cash equivalents. ASU 2016-18 does not define restricted cash or restricted cash equivalents, but an entity will need to disclose the nature of the restrictions. ASU 2016-18 is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2017. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, adjustments should be reflected at the beginning of the fiscal year that includes that interim period. Entities should apply this ASU using a retrospective transition method to each period presented. 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 March 2017, the FASB issued ASU No. 2017-07, ("ASU 2017-07"), Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost. ASU 2017-07 requires that the service cost component be disaggregated from the other components of net benefit cost and provides guidance for separate presentation in the income statement. ASU 2017-07 also changes the rules for capitalization of costs such that only the service cost component of net benefit cost may be capitalized rather than total net benefit cost. ASU 2017-07 will be effective for fiscal years and interim periods beginning after December 15, 2017. ASU 2017-07 is required to be applied retrospectively for the income statement presentation and prospectively for the capitalization of the service cost component of net periodic pension cost. The Company is currently in the process of evaluating the impact of adoption on its consolidated financial statements.

In May 2017, the FASB issued ASU No. 2017-09 ("ASU 2017-09"), Scope of Modification Accounting. ASU 2017-09 clarifies when to account for a change to the terms or conditions of a share-based payment award as a modification. Under the new guidance, modification accounting is required only if the fair value, the vesting conditions, or the classification of the award (as equity or liability) changes as a result of the change in terms or conditions. ASU 2017-09 is effective for all entities for fiscal years beginning after December 15, 2017, including interim periods within those years. 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.

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 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.

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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 third quarter and first three quarters of fiscal year 2018 compared to the third quarter and first three quarters of fiscal year 2017. 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 Third Quarter of Fiscal Year 2018 compared to the Third Quarter of Fiscal Year 2017

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

CONSOLIDATED

| | For the Third Quarter of Fiscal Years | | | |
|---|---|---|---|---|
| | 2018 | % of Sales | 2017 | % of Sales |
| Net sales | $93,938 | 100.0 % | $95,410 | 100.0 % |
| Cost of goods sold | 76,262 | 81.2 | 78,495 | 82.3 |
| Gross profit | 17,676 | 18.8 | 16,915 | 17.7 |
| Selling and administrative expenses | 13,253 | 14.1 | 12,862 | 13.5 |
| Internal research and development expenses | 307 | 0.3 | 424 | 0.4 |
| Amortization of intangible assets | 1,802 | 1.9 | 2,099 | 2.2 |
| Operating income | 2,314 | 2.5 | 1,530 | 1.6 |
| Other expense, net | (1,460 ) | (1.6 ) | (1,055 ) | (1.1 ) |
| Income (loss) before income taxes | 854 | 0.9 | 475 | 0.5 |
| Income taxes | 239 | 0.2 | 46 | (0.1 ) |
| Net income | $615 | 0.7 % | $429 | 0.4 % |

The decrease in net sales was the result of a $1.7 million sales decrease in our MDS segment, which was partially offset by a $0.2 million sales increase in our ECP segment. The increase in our gross margin was primarily due to a sales mix shift from lower gross margin MDS sales to higher gross margin ECP sales and an improvement in both MDS and ECP gross margin. Selling and administrative expense was higher due to legal costs and performance-based bonuses, which were partially mitigated by the continued focused effort on cost containment and expense reduction. During the third quarter of fiscal year 2017, the Company recognized a discrete income tax benefit of $0.1 million related to the conclusion of a state tax audit. 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. Excluding the discrete tax events described above, the Company's estimated annual effective income tax rate for the fiscal years 2018 and 2017 was determined to be approximately 28% and 35%, respectively. The difference in rates is due primarily to the impact of the Tax Cut and Job Act of 2017 discussed below.

Due to the factors described above, the Company reported a net income of $0.6 million, or $0.06 earnings per share, basic and diluted, for the third quarter of fiscal year 2018, compared to net income of $0.4 million, or $0.04 earnings per share, basic and diluted, for the third quarter of fiscal year 2017.

Segment Information

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

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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 Third Quarter of Fiscal Years | | | | |
|---|---|---|---|---|---|
| | 2018 | % of Sales | 2017 | % of Sales | $ Chg |
| Gross sales | $59,786 | 100.0 % | $61,084 | 100.0 % | $(1,298) |
| Intercompany sales | (3,039) | (5.1) | (2,654) | (4.3) | (385) |
| Net sales | 56,747 | 94.9 | 58,430 | 95.7 | (1,683) |
| Gross profit | 7,164 | 12.0 | 6,690 | 11.0 | 474 |
| Selling and administrative expenses | 5,487 | 9.2 | 5,684 | 9.3 | (197) |
| Amortization of intangible assets | 1,473 | 2.5 | 1,728 | 2.9 | (255) |
| Operating income (loss) | $204 | 0.3 % | $(722) | (1.2)% | $926 |

The $1.7 million decrease in net sales was due to prior year insourcing in our medical end-market and the loss of a customer in our industrial end-market reducing sales by $2.8 million and program delays and volume reductions of $13.1 million. These losses were partially offset by revenues from new program wins and increased volumes with other customers of $14.2 million. MDS backlog was $149.1 million at the end of the third quarter of fiscal year 2018 compared to $118.0 million at the end of the third quarter of fiscal year 2017. 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 April 1, 2018 MDS backlog is currently expected to be realized in the next 12 months.

Gross margin increased slightly as a result of favorable sales mix. The decrease in selling and administrative expense was due primarily to lower corporate allocations.

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ECP

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

| | For the Third Quarter of Fiscal Years | | | | |
|---|---|---|---|---|---|
| | 2018 | % of Sales | 2017 | % of Sales | $ Chg |
| Gross sales | $37,199 | 100.0 % | $37,053 | 100.0 % | $146 |
| Intercompany sales | (8) | — | (73) | (0.2) | 65 |
| Net sales | 37,191 | 100.0 | 36,980 | 99.8 | 211 |
| Gross profit | 10,512 | 28.3 | 10,225 | 27.6 | 287 |
| Selling and administrative expenses | 3,454 | 9.3 | 4,160 | 11.2 | (706) |
| Internal research and development expenses | 307 | 0.8 | 424 | 1.2 | (117) |
| Amortization of intangible assets | 329 | 0.9 | 371 | 1.0 | (42) |
| Operating income | $6,422 | 17.3 % | $5,270 | 14.2 % | $1,152 |

The $0.2 million increase in net sales was due to a $3.4 million increase in foreign sonobuoy sales, offset by a $1.9 million decrease in domestic sonobuoy sales, a $0.1 million decrease in rugged electronics sales and $1.2 million decrease in the combined engineering and other revenue streams. Total sales to the U.S. Navy in the third quarter of fiscal years 2018 and 2017 were $17.4 million and $19.7 million, respectively. For the third quarter of fiscal years 2018 and 2017, sales to the U.S. Navy accounted for 18% and 21%, respectively, of consolidated Company net sales and 47% and 53%, respectively, of ECP segment net sales. ECP backlog was $157.1 million at the end of the third quarter of fiscal year 2018 compared to $124.4 million at the end of the third quarter of fiscal year 2017. Substantially all of the April 1, 2018 ECP backlog is currently expected to be realized in the next 18 months.

Gross margin increased due to favorable sales mix. Selling and administrative expense decreased due to site spending controls.

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 third quarter of fiscal year 2018, ECP reduced internal research and development spending by $0.1 million as compared to the same period in fiscal year 2017.

Eliminations and Corporate Unallocated

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

| | For the Third Quarter of Fiscal Years | | |
|---|---|---|---|
| | 2018 | 2017 | $ Chg |
| Intercompany sales elimination | $(3,047) | $(2,727) | $(320) |
| Selling and administrative expenses unallocated | 4,312 | 3,018 | 1,294 |

Total corporate selling and administrative expenses before allocation to operating segments were $7.7 million and $6.7 million for the third quarter of fiscal year 2018 and fiscal year 2017, respectively, or 8.2% and 7.1% of consolidated sales, respectively. Of these costs, $3.4 million and $3.7 million, respectively, were allocated to segment operations in each of these periods. The increase in corporate selling and administrative expenses was due primarily to legal costs and performance-based bonuses.

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For the First Three Quarters of Fiscal Year 2018 compared to the First Three Quarters of Fiscal Year 2017
The following table presents selected consolidated statement of operations data (dollars in thousands):
CONSOLIDATED

| | For the First Three Quarters of Fiscal Years | | | |
|---|---|---|---|---|
| | 2018 | % of Sales | 2017 | % of Sales |
| Net sales | $274,520 | 100.0 % | $293,176 | 100.0 % |
| Cost of goods sold | 221,827 | 80.8 | 243,078 | 82.9 |
| Gross profit | 52,693 | 19.2 | 50,098 | 17.1 |
| Selling and administrative expenses | 42,532 | 15.5 | 39,198 | 13.4 |
| Internal research and development expenses | 1,548 | 0.6 | 1,308 | 0.5 |
| Amortization of intangible assets | 5,618 | 2.0 | 6,509 | 2.2 |
| Operating income | 2,995 | 1.1 | 3,083 | 1.0 |
| Other expense, net | (4,230 ) | (1.5 ) | (3,298 ) | (1.1 ) |
| Loss before income taxes | (1,235 ) | (0.4 ) | (215 ) | (0.1 ) |
| Income taxes | 10,036 | 3.7 | 155 | — |
| Net loss | $(11,271 ) | (4.1 )% | $(370 ) | (0.1 )% |

The decrease in net sales was the result of a $21.8 million sales reduction in our MDS segment, which was partially offset by a $3.1 million sales increase in our ECP segment.
The increase in gross margin was due to a sales mix shift from lower gross margin MDS sales to higher margin ECP sales and improvements in ECP gross margin. The increase in selling and administrative expense was higher due to legal and advisory costs associated with the proposed Merger with Ultra, other legal costs and performance-based bonuses, which were partially offset by the continued focused effort on cost containment and expense reduction.
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. The new tax rate is effective January 1, 2018. For corporations that report on a fiscal year basis, the Tax Act requires the use of a full-year blended income tax rate based on the new and old rates. Based on a federal rate of 35% for the first two quarters of fiscal year 2018 and 21% for the last two quarters of fiscal year 2018, as well as other factors, the Company estimated its annual effective income tax rate for fiscal year 2018 will be approximately 28%, exclusive of any discrete tax events. During the second quarter of fiscal year 2018, as a result of the Tax Act, the Company recorded income tax expense of $10.1 million for a provisional reduction in its net deferred tax assets and $0.4 million for a provisional liability related to unrepatriated earnings and profits of foreign subsidiaries.
During the second quarter of fiscal year 2018, the Company recognized the impacts of the Tax Act as discrete income tax events. Additionally, the Company recognized a discrete income tax benefit of $0.1 million during the second quarter of fiscal year 2018 as a result of the filing of the fiscal year 2017 tax return as well as amending certain tax returns from earlier tax years. The Company recognized a discrete income tax benefit of $0.1 million in the third quarter of fiscal year 2017 related to the conclusion of a state tax audit and a discrete income tax expense of $0.4 million in the second quarter of fiscal year 2017 related to its Vietnam subsidiary.
Excluding the discrete tax events and the adjustment of the income tax benefit recorded in the first quarter of fiscal year 2018, described above, the Company's estimated annual effective income tax rate for the first three quarters of fiscal years 2018 and 2017 was determined to be approximately 28% and 35%, respectively.
Due to the factors described above, the Company reported a net loss of $11.3 million, or $1.15 loss per share for the first three quarters of fiscal year 2018, compared to a net loss of $0.4 million, or $0.04 loss per share for the first three quarters of fiscal year 2017.

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MDS

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

| | For the First Three Quarters of Fiscal Years | | | | |
|---|---|---|---|---|---|
| | 2018 | % of Sales | 2017 | % of Sales | $ Chg |
| Gross sales | $173,447 | 100.0 % | $193,468 | 100.0 % | $(20,021) |
| Intercompany sales | (8,945) | (5.2) | (7,187) | (3.7) | (1,758) |
| Net sales | 164,502 | 94.8 | 186,281 | 96.3 | (21,779) |
| Gross profit | 20,116 | 11.6 | 22,341 | 11.6 | (2,225) |
| Selling and administrative expenses | 17,001 | 9.8 | 17,221 | 8.9 | (220) |
| Amortization of intangible assets | 4,604 | 2.7 | 5,370 | 2.8 | (766) |
| Operating income (loss) | $(1,489) | (0.9)% | $(250) | (0.1)% | $(1,239) |

The $21.8 million decrease in net sales was due to (i) the prior year insourcing in our medical end-market and the loss of a customer in our industrial end-market reducing sales by $27.2 million and (ii) program delays and volume reductions of $30.7 million. These losses were offset by revenues from new programs wins and increased volumes with other customers of $36.1 million. Gross margin was flat compared to the same period in fiscal year 2017, as the impact of lower absorption of fixed overhead costs due to lower sales was offset by a more favorable sales mix. Selling and administrative expenses were essentially flat.

ECP

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

| | For the First Three Quarters of Fiscal Years | | | | |
|---|---|---|---|---|---|
| | 2018 | % of Sales | 2017 | % of Sales | $ Chg |
| Gross sales | $110,065 | 100.0 % | $106,995 | 100.0 % | $3,070 |
| Intercompany sales | (47) | — | (100) | (0.1) | 53 |
| Net sales | 110,018 | 100.0 | 106,895 | 99.9 | 3,123 |
| Gross profit | 32,577 | 29.6 | 27,757 | 26.0 | 4,820 |
| Selling and administrative expenses | 10,604 | 9.6 | 11,529 | 10.8 | (925) |
| Internal research and development expenses | 1,548 | 1.4 | 1,308 | 1.2 | 240 |
| Amortization of intangible assets | 1,014 | 1.0 | 1,139 | 1.1 | (125) |
| Operating income | $19,411 | 17.6 % | $13,781 | 12.9 % | $5,630 |

The increase in net sales of $3.1 million is due to a $5.9 million increase in domestic sonobuoy sales and a $2.2 million increase in foreign sonobuoy sales, partially offset by decreased revenue of $2.7 million in engineering and rugged electronics and other combined of $2.3 million. Total sales to the U.S. Navy in the first three quarters of fiscal years 2018 and 2017 were approximately $64.9 million and $61.8 million, respectively. For the first three quarters of fiscal years 2018 and 2017, sales to the U.S. Navy accounted for 24% and 21%, respectively, of consolidated Company net sales and 59% and 58%, respectively, of ECP segment net sales.

Gross margin was positively impacted in the current year by favorable sales mix and lower overhead as the prior year was negatively impacted by unabsorbed fixed overhead costs due to new program launch activity. The selling and administrative expenses decreased due to site spending controls.

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. In the first three quarters of fiscal year 2018, ECP increased internal research and development spending $0.2 million as compared to the same period in fiscal year 2017.

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Eliminations and Corporate Unallocated

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

| | For the First Three Quarters of Fiscal Years | | |
|---|---|---|---|
| | 2018 | 2017 | $ Chg |
| Intercompany sales elimination | $(8,992) | $(7,287) | $(1,705) |
| Selling and administrative expenses unallocated | 14,927 | 10,448 | 4,479 |

Total corporate selling and administrative expenses before allocation to operating segments were $24.9 million and $21.0 million for the first three quarters of fiscal year 2018 and fiscal year 2017, respectively, or 9.1% and 7.2% of consolidated sales, respectively. Of these costs, $10.0 million and $10.6 million, respectively, were allocated to segment operations in each of these periods. The increase in corporate selling and administrative expenses was due primarily to legal and advisory costs associated with the proposed Merger with Ultra, other legal costs and performance-based bonuses.

Liquidity and Capital Resources

As of April 1, 2018, the Company had $24.0 million available under its $125.0 million credit facility, reflecting borrowings under the facility of $96.8 million, outstanding letters of credit of $3.9 million and capital leases of $0.2 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%. Expenses of approximately $1.3 million related to Amendment 5 will be recorded as interest expense in the fourth quarter of fiscal year 2018.

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. The Company has met this covenant for the quarter ended April 1, 2018 and anticipates compliance for the quarter ended July 1, 2018. Beginning with the fiscal quarter ended September 30, 2018 and thereafter, the funded debt to EBITDA ratio will be 3.0x. The covenant relief was provided as the Company completes its exploration of a potential sale transaction. In the event that the Company does not consummate a sales transaction prior to September 30, 2018, 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 Three Quarters of Fiscal Years | |
|---|---|---|
| CASH FLOWS | 2018 | 2017 |
| Operating activities, excluding net changes in working capital | $9,970 | $11,830 |
| Net changes in working capital | (28,320) | 3,676 |
| Operating activities | (18,350) | 15,506 |
| Investing activities | (3,756) | (4,812) |
| Financing activities | 21,910 | (9,794) |

Net changes in working capital related cash flows in the first three quarters of fiscal year 2018 primarily reflect increased accounts receivables and inventories as well as reduced performance based payments, which were partially offset by increased accounts payable. Working capital related cash flows in the first three quarters of fiscal year 2017 primarily reflect reduced inventories, partially offset by decreased accounts payable and accrued expenses.

Net cash used in investing activity for the first three quarters of fiscal year 2018 and 2017 reflect net capital expenditures of $3.8 million and $4.8 million, respectively.

Net cash provided by financing activities in the first three quarters of fiscal year 2018 reflects $22.3 million of net borrowings under the Company's Credit Facility as compared to $9.6 million in net payments for the first three quarters of fiscal year 2017.

## Commitments and Contingencies

See Note 8, 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 2, 2017. As of July 2, 2017, there were $45.6 million of non-cancelable purchase orders outstanding, $74.5 million of debt, $13.6 million of operating lease payments and a liability related to performance based billings was $1.7 million. As of April 1, 2018, compared to July 2, 2017, the non-cancelable purchase orders outstanding increased to $51.3 million, debt increased to $96.8 million, operating lease payments, net of subleases, decreased to $12.1 million and there was no liability related to performance based billings. 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 2017.

## Off-Balance Sheet Arrangements

The Company has standby letters of credit outstanding of $3.9 million at April 1, 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 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

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 fiscal year ended July 2, 2017.

## New Accounting Pronouncements

See Note 12, 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

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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 $96.8 million outstanding under its Credit Facility at April 1, 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 $1.0 million in our annual interest expense. The Company is not party to any currency exchange or interest rate protection agreements as of April 1, 2018.

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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.

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 third quarter of fiscal year 2018 ended April 1, 2018, 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 8, 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 2, 2017 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 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. |
| 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. |
| 10.2 | Amendment No. 5 dated May 3, 2018 to the Amended and Restated Credit and Guaranty Agreement dated September 11, 2014, entered into between BMO Harris Bank N.A. and the Borrowers, incorporated by reference from Form 8-K filed with the SEC on May 7, 2018. |
| 31.1* | Interim 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* | 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. |
| 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: May 9, 2018 By: /s/ JOSEPH J. HARTNETT
Joseph J. Hartnett
Interim President and Chief Executive Officer
(Principal Executive Officer)

Date: May 9, 2018 By: /s/ JOSEPH G. MCCORMACK
Joseph G. McCormack
Senior Vice President and Chief Financial Officer
(Principal Financial Officer)