KEY TECHNOLOGY INC
Form 10-Q
February 03, 2017

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

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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 December 31, 2016

or

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
for the transition period from ____ to ____

Commission File No. 0-21820

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KEY TECHNOLOGY, INC.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Oregon | 93-0822509 |
| (State or jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

150 Avery Street
Walla Walla, Washington 99362
(Address of principal executive offices and zip code)

(509) 529-2161
(Registrant's telephone number, including area code)

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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 Web site, 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 for 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, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer,” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

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

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

The number of shares outstanding of the registrant's common stock, no par value, on January 31, 2017 was 6,402,725 shares.

KEY TECHNOLOGY, INC.
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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

KEY TECHNOLOGY, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 2016 AND SEPTEMBER 30, 2016

| | December 31, 2016 | September 30, 2016 |
|---|---|---|
| Assets | (in thousands) | |
| Current assets: | | |
| Cash and cash equivalents | $7,210 | $ 10,491 |
| Trade accounts receivable, net of allowance for doubtful accounts of $256 and $266, respectively | 16,301 | 14,024 |
| Inventories: | | |
| Raw materials | 12,974 | 11,690 |
| Work-in-process and sub-assemblies | 14,267 | 12,191 |
| Finished goods | 6,570 | 6,806 |
| Total inventories | 33,811 | 30,687 |
| Deferred income taxes | 3,924 | 3,934 |
| Prepaid expenses and other assets | 3,683 | 3,285 |
| Total current assets | 64,929 | 62,421 |
| Property, plant and equipment, net | 13,299 | 13,789 |
| Deferred income taxes | 3,268 | 3,001 |
| Goodwill | 9,759 | 10,277 |
| Investment in Proditec | 1,127 | 1,127 |
| Intangibles and other assets, net | 4,780 | 5,369 |
| Total | $97,162 | $ 95,984 |
| | | |
| Liabilities and Shareholders' Equity | | |
| Current liabilities: | | |
| Accounts payable | $8,764 | $ 7,381 |
| Accrued payroll liabilities and commissions | 5,339 | 4,932 |
| Customers' deposits | 10,536 | 9,139 |
| Accrued customer support and warranty costs | 2,045 | 2,197 |
| Customer purchase plans | 754 | 1,124 |
| Current portion of long-term debt | 527 | 587 |
| Other accrued liabilities | 702 | 956 |
| Total current liabilities | 28,667 | 26,316 |
| Long-term debt | 4,446 | 4,565 |
| Deferred income taxes | 1,557 | 1,761 |
| Other long-term liabilities | 301 | 348 |
| Shareholders' equity: | | |
| Common stock | 34,274 | 34,237 |
| Retained earnings and other shareholders' equity | 27,917 | 28,757 |
| Total shareholders' equity | 62,191 | 62,994 |
| Total | $97,162 | $ 95,984 |

See notes to unaudited condensed consolidated financial statements.

KEY TECHNOLOGY, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE THREE MONTHS ENDED DECEMBER 31, 2016 AND 2015

| | Three Months Ended December 31, | |
|---|---|---|
| | 2016 | 2015 |
| | (in thousands, except per share data) | |
| Net sales | $27,363 | $24,803 |
| Cost of sales | 18,133 | 17,823 |
| Gross profit | 9,230 | 6,980 |
| Operating expenses: | | |
| Sales and marketing | 4,318 | 4,070 |
| Research and development | 2,494 | 2,279 |
| General and administrative | 2,092 | 2,685 |
| Amortization of intangibles | 227 | 349 |
| Total operating expenses | 9,131 | 9,383 |
| Gain on disposition of assets | 2 | 8 |
| Earnings (loss) from operations | 101 | (2,395) |
| Other income (expense) | (78) | (339) |
| Earnings (loss) before income taxes | 23 | (2,734) |
| Income tax expense (benefit) | 8 | (1,035) |
| Net earnings (loss) | $15 | $(1,699) |
| | | |
| Net earnings (loss) per share | | |
| - basic | $0.00 | $(0.27) |
| - diluted | $0.00 | $(0.27) |
| | | |
| Shares used in per share calculations - basic | 6,375 | 6,261 |
| | | |
| Shares used in per share calculations - diluted | 6,375 | 6,261 |

See notes to unaudited condensed consolidated financial statements.

KEY TECHNOLOGY, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
FOR THE THREE MONTHS ENDED DECEMBER 31, 2016 AND 2015

| | Three Months Ended December 31, | |
|---|---|---|
| | 2016 | 2015 |
| | (in thousands) | |
| Net earnings (loss) | $15 | $(1,699) |
| Other comprehensive income (loss): | | |
| Foreign currency translation adjustment | (1,301) | (605) |
| Reclassification adjustment for foreign currency translation included in net earnings (loss) | 6 | 6 |
| Income tax (expense) benefit related to items of comprehensive income (loss) | 441 | 204 |
| Total comprehensive loss | $(839) | $(2,094) |

See notes to unaudited condensed consolidated financial statements.

KEY TECHNOLOGY, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE THREE MONTHS ENDED DECEMBER 31, 2016 AND 2015

| | Three Months Ended December 31, | |
|---|---|---|
| | 2016 | 2015 |
| | (in thousands) | |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net earnings (loss) | $ 15 | $ (1,699) |
| Adjustments to reconcile net earnings (loss) to net cash used in operating activities: | | |
| Gain on disposition of assets | (2) | (8) |
| Foreign currency exchange (gain) loss | (75) | 188 |
| Depreciation and amortization | 1,016 | 1,331 |
| Share based payments | 262 | 326 |
| Reclassification from other comprehensive income | 6 | 6 |
| Excess tax benefits from share based payments | — | (5) |
| Deferred income taxes | 29 | (648) |
| Change in fair value of derivatives | (46) | — |
| Deferred rent | 2 | 2 |
| Bad debt expense | — | 5 |
| Changes in assets and liabilities: | | |
| Trade accounts receivable | (2,652) | 2,298 |
| Inventories | (3,863) | (1,683) |
| Prepaid expenses and other current assets | (384) | 299 |
| Income taxes receivable | — | (378) |
| Intangibles and other long term assets | — | (33) |
| Accounts payable | 1,530 | (1,834) |
| Accrued payroll liabilities and commissions | 557 | 28 |
| Customers’ deposits | 1,830 | 3,169 |
| Accrued customer support and warranty costs | (91) | (125) |
| Income taxes payable | (24) | (15) |
| Other accrued liabilities | (524) | 76 |
| Other | (1) | 3 |
| Cash used in operating activities | (2,415) | (697) |
| | | |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Proceeds from sale of property | 2 | 12 |
| Purchases of property, plant and equipment | (393) | (253) |
| Cash used in investing activities | (391) | (241) |

See notes to unaudited condensed consolidated financial statements. (Continued)

KEY TECHNOLOGY, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE THREE MONTHS ENDED DECEMBER 31, 2016 AND 2015

| | Three Months Ended December 31, | |
|---|---|---|
| | 2016 | 2015 |
| | (in thousands) | |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Payments on long-term debt | (163 ) | (177 ) |
| Excess tax benefits from share based payments | — | 5 |
| Proceeds from issuance of common stock | 9 | 13 |
| Exchange of shares for statutory withholding | (212 ) | (254 ) |
| Cash used in financing activities | (366 ) | (413 ) |
| EFFECT OF EXCHANGE RATE CHANGES ON CASH | (109 ) | (1 ) |
| NET DECREASE IN CASH AND CASH EQUIVALENTS | (3,281 ) | (1,352 ) |
| CASH AND CASH EQUIVALENTS, BEGINNING OF THE PERIOD | 10,491 | 7,726 |
| CASH AND CASH EQUIVALENTS, END OF THE PERIOD | $7,210 | $ 6,374 |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: | | |
| Cash paid during the period for interest | $84 | $ 110 |
| Cash paid during the period for income taxes | $3 | $ 5 |

See notes to unaudited condensed consolidated financial statements. (Concluded)

KEY TECHNOLOGY, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED DECEMBER 31, 2016

1. Unaudited condensed consolidated financial statements

Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) have been omitted from these unaudited condensed consolidated financial statements. These unaudited condensed consolidated financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2016. The results of operations for the three month period ended December 31, 2016 are not necessarily indicative of the operating results for the full year.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and assumptions.

In the opinion of management, all adjustments, consisting only of normal recurring accruals, have been made to present fairly the Company's financial position at December 31, 2016 and the results of its operations and its cash flows for the three month period ended December 31, 2016 and 2015.

Recent Accounting Pronouncements Not Yet Adopted

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standard Update (“ASU”) 2014-09, “Revenue from Contracts with Customers” (“ASU 2014-09”). ASU 2014-09 supersedes nearly all existing revenue recognition guidance under GAAP. The standard’s core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the Company expects to be entitled in exchange for those goods or services. We are evaluating our existing revenue recognition policies to determine whether any contracts in the scope of the guidance will be affected by the new requirements. ASU 2014-09, as amended by ASU 2015-14, is effective for annual reporting periods beginning after December 15, 2017, including interim periods therein.

In July 2015, the FASB issued ASU 2015-11, "Simplifying the Measurement of Inventory" ("ASU 2015-11"). The previous standard required entities to measure inventory at the lower of cost or market, with market defined as net realizable value or replacement cost. ASU 2015-11 requires entities to measure inventory at the lower of cost and net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. ASU 2015-11 is effective for annual reporting periods beginning after December 15, 2016, including interim periods therein. The Company does not anticipate that it will have a material effect on its financial statements.

In November 2015, the FASB issued ASU 2015-17, "Balance Sheet Classification of Deferred Taxes," which eliminates the current requirement to present deferred tax liabilities and assets as current and non-current in a classified balance sheet. Instead, entities will be required to classify all deferred tax assets and liabilities as non-current. This ASU will be effective for the Company beginning in its first quarter of fiscal year 2018 and may be adopted prospectively or retrospectively. Early adoption is permitted but the Company has not elected to do so. The Company does not expect its adoption to have a material effect on its financial statements.

In February 2016, the FASB issued ASU 2016-02, "Leases" (“ASU 2016-02”), which is intended to improve financial reporting about leasing transactions. ASU 2016-02 will require lessees to recognize the assets and liabilities for the rights and obligations created by those leases on their balance sheet. Lessees will be required to recognize assets and liabilities for leases with lease terms of more than 12 months. ASU 2016-02 is effective for public companies for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted. The Company has not yet determined the effect that adoption of ASU 2016-02 will have on its consolidated financial position and consolidated results of operations.

In March 2016, the FASB issued ASU 2016-09, "Stock Compensation," which is intended to simplify several aspects of the accounting for share-based payment award transactions, including adjustments to the timing of when excess tax benefits should be recorded and classification in the statement of cash flows. The guidance will be effective for fiscal years beginning after December 15, 2016, including interim periods within those years. The Company does not anticipate that the adoption of this ASU will materially impact its results of operations.

2. Share-based compensation

During the three months ended December 31, 2016, the Company granted 37,676 shares of service-based stock awards. The fair value of these grants was $10.68 per share based on the fair market value at the grant date. The restrictions on these shares lapse at the end of the required service periods ranging from October 2017 through October 2019.

Share-based compensation expense included in the Company's results was as follows (in thousands):

| | Three Months Ended December 31, | |
|---|---|---|
| | 2016 | 2015 |
| Cost of goods sold | $46 | $39 |
| Operating expenses | 216 | 287 |
| Total share-based compensation expense | $262 | $326 |

Share-based compensation expense remaining capitalized in inventory was $22,000 at December 31, 2016 and 2015.

3. Earnings (loss) per share

The weighted-average number of diluted shares does not include the potential issuance of common shares which are anti-dilutive. Common stock equivalent shares for the assumed exercise of warrants are calculated using the treasury stock method. The following potentially issuable common shares at December 31, 2016 and 2015 were not included in the calculation of diluted EPS as they were anti-dilutive:

| | Three Months Ended December 31, | |
|---|---|---|
| | 2016 | 2015 |
| Common shares from: | | |
| Warrants | — | 250,000 |

The warrants expired in March 2016, and there were no warrants exercised.

4. Income taxes

The provision (benefit) for income taxes is based on the estimated effective income tax rate for the year. Changes in the estimated effective income tax rate are accounted for in the period the change in estimate occurs. During the first quarter of fiscal 2016, the research and development tax credit was permanently renewed retroactive to January 1, 2015. In the first quarter of fiscal 2016, income tax expense was reduced by approximately $106,000 for additional research and development tax credits related to expenditures incurred during fiscal 2015 due to the renewal of this tax credit.

5. Derivative instruments

The Company uses derivative instruments as risk management tools but does not use derivative instruments for trading or speculative purposes. A hedge is deemed effective if changes in the fair value of the derivative contract are highly correlated with changes in the underlying hedged item at inception of the hedge and over the life of the hedge contract. To the extent the interest rate swap is effective, changes in fair value will be recognized in Other Comprehensive Income over the term of the derivative contract. To the extent the interest rate swap is not effective, changes in fair value will be recognized in earnings.

At December 31, 2016, the Company had an interest rate swap with a notional amount of $4.8 million that fixes the interest rate on its LIBOR-based variable rate mortgage at 6.20%. At December 31, 2016, the fair value of the swap agreement recorded as a liability in Other long-term liabilities on the Unaudited Condensed Consolidated Balance Sheet was $131,000. There were gains of $46,000 recognized as part of net earnings in the Unaudited Condensed Consolidated Statements of Operations related to the swap agreement during the three month period ended December 31, 2016, because the interest rate swap was not designated as a hedge due to its ineffectiveness. During the three month period ended December 31, 2016, the Company recorded $29,000 as interest expense related to the interest rate swap reflecting actual interest payments and settlements on the interest rate swap. The interest rate swap matures in July 2018. The fair value of a previous interest rate swap is being amortized into earnings from Other Comprehensive Income over the original forecasted settlement period of the swap as it is no longer designated as a hedge. As a result, the Company amortized $6,000 of losses from Other Comprehensive Income into net earnings during the three month period ended December 31, 2016.

At December 31, 2016, the Company had a one-month undesignated forward exchange contract for €3.5 million ($3.7 million). Forward exchange contracts are used to manage the Company's foreign currency exchange risk related to its ongoing operations. Net foreign currency gains of $262,000 were recorded for forward exchange contracts in the three month period ended December 31, 2016 as a component of foreign currency gains or losses in Other income (expense) on the Company's Unaudited Condensed Consolidated Statements of Operations. The gains or losses on the Company's forward exchange contracts are generally offset by gains or losses recorded on the underlying assets or liabilities held in foreign currencies. At December 31, 2016, the Company had assets of $17,000 for settlements under these forward exchange contracts in Other current assets on the Company's Unaudited Condensed Consolidated Balance Sheet.

6. Fair value measurements

Fair value measurements are classified under the following hierarchy:

- Level 1 – Quoted prices for identical instruments in active markets.
- Level 2 – Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs or significant value-drivers are observable in active markets.
- Level 3 – Model-derived valuations in which one or more significant inputs or significant value-drivers are unobservable.

When available, the Company uses quoted market prices to determine fair value and classify such measurements within Level 1. In some cases where market prices are not available, the Company makes use of observable market-based inputs to calculate fair value, in which case the measurements are classified within Level 2. If quoted or observable market processes are not available, fair value is based upon internally developed models that use, where possible, current market-based parameters such as interest rates, yield curves and currency rates. These measurements are classified within Level 3.

Derivative financial instruments

Interest rate swap agreements are measured on a recurring basis based on quoted prices for similar financial instruments and other observable inputs which approximate fair value. The fair value of foreign currency forward contracts is based on the differential between contract price and the market-based forward rate.

The following table presents the Company's assets and liabilities that are measured and recorded at fair value on a recurring basis consistent with the fair value hierarchy provisions:

| | Fair Value Measurements at December 31, 2016 (in thousands) | | | |
|---|---|---|---|---|
| Description | Level 1 | Level 2 | Level 3 | Total Assets/ (Liabilities) at |

| | | | Fair Value |
|---|---|---|---|
| Derivatives: | | | |
| Interest rate swap | —$(131) | — | $ (131 ) |
| Forward exchange contracts | — | — | — |

At December 31, 2016, the Company also had long-term debt of approximately $5.0 million. The Company's long-term debt is recorded at historical cost and the Company has not elected to value such financial instruments at fair value. The fair value of the debt approximated its carrying value based on the borrowing rates currently available to the Company for loans with similar terms and maturities.

Fair value estimates are made at a specific point in time based on relevant market information and information about the financial instrument. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Forward exchange contracts had a fair value of zero at the reporting date, as these contracts were entered into as of that date. Changes in assumptions could significantly affect these estimates.

At December 31, 2016, the Company's non-controlling interest in Proditec SAS had a carrying value of approximately $1.1 million. This investment is being accounted for under the cost method. The fair value of the Company's investment in Proditec was not estimated as there were no events or changes in circumstances that may have had a significant adverse effect on the fair value of the investment, and our management determined that it was not practicable to estimate the fair value of the investment. Further, there are no quoted market prices for the Company's investment, and sufficient information is not readily available for the Company to utilize a valuation model to determine its fair value without incurring excessive costs relative to the materiality of the investment. The Company's cost method investment is evaluated for potential other-than-temporary impairment on at least a quarterly basis or when an event or change in circumstances has occurred that may have a significant adverse effect on the fair value of the investment.

7. Financing arrangements

The Company's domestic credit facility provides for a maximum of $20.3 million consisting of a three-year term loan of $5.3 million and revolving loans up to the lesser of $15.0 million or a borrowing base calculated based on the outstanding amount of the Company's eligible accounts receivable and eligible inventory. The credit facility also provides for a credit sub-facility of up to $4.0 million for standby letters of credit. The credit facility matures on July 19, 2018. The revolving credit facility bears interest, at the Company's option, at either the lender's base lending rate or LIBOR using a tiered structure depending on the Company's achievement of a specified financial ratio. The Company's base lending rate option is the lender's base lending rate plus 0.75%, 1.00% or 1.25% per annum. The Company's LIBOR option is LIBOR plus 2.25%, 2.50% or 2.75%. At December 31, 2016, the interest rate would have been 3.02% based on the lowest of the available alternative rates. The term loan bears interest, at the Company's option, at either the lender's base lending rate plus 1.75% or the one-, two-, or three-month LIBOR rate plus 3.25%. The Company also simultaneously entered into an interest rate swap agreement with the lender to fix the term loan interest rate at 6.20%. The credit facility is secured by the Company's receivables, equipment and fixtures, inventory, general intangibles, subsidiary stock, securities, investment property, financial assets, real property, and certain other assets. The credit facility contains covenants related to minimum liquidity levels and certain financial covenants that will be applicable only if the Company does not exceed certain calculated total unrestricted cash and credit availability or an event of default occurs. The credit facility permits capital expenditures to a certain level and contains customary default and acceleration provisions. The credit facility also restricts, above certain levels, acquisitions, incurrence of additional indebtedness, payment of dividends and lease expenditures. At December 31, 2016, the Company had no outstanding borrowings under the revolving line of credit and $0.9 million of outstanding standby letters of credit.

The Company's Belgian subsidiary has a credit accommodation with a commercial bank in Belgium. This credit accommodation totals €2.7 million ($2.8 million) and includes an operating line of €800,000 ($0.8 million), a bank guarantee facility of €500,000 ($0.5 million), and loan agreement provisions of €1.4 million ($1.5 million). The operating line and bank guarantee facility are secured by all of the subsidiary's current assets. The Belgian operating line bears interest at the bank's prime rate, plus 1.25%. At December 31, 2016, the interest rate was 9.75% and the subsidiary had no borrowings under the operating line. At December 31, 2016, the subsidiary had various loans outstanding under the loan agreement provisions totaling €165,000 ($174,000). The fixed interest rates on these loans ranged from 3.68% to 3.98%. The loans mature between February 2017 and November 2017. At December 31, 2016, the subsidiary had no bank guarantees outstanding under the bank guarantee facility.

8. Contractual guarantees and indemnities

Product warranties

The Company provides warranties on its products ranging from ninety days to five years following the date of shipment, the majority of which are for periods of one year or less. Management establishes allowances for warranty costs based upon the types of products shipped and product warranty experience. The provision for warranty costs is charged to cost of sales at the time of sale, and it is periodically assessed for adequacy based on changes in these factors.

A reconciliation of the changes in the Company's allowances for warranties for the three months ended December 31, 2016 and 2015 is as follows (in thousands):

| | Three Months Ended December 31, 2016 | 2015 |
|---|---|---|
| Beginning balance | $1,932 | $2,255 |
| Warranty costs incurred | (567 ) | (739 ) |
| Warranty expense accrued | 378 | 624 |
| Translation adjustments | (52 ) | (27 ) |
| Ending balance | $1,691 | $2,113 |

Intellectual property and general contractual indemnities

The Company, in the normal course of business, provides specific, limited indemnification to its customers for liability and damages related to intellectual property rights. In addition, the Company may enter into contracts with customers where it agrees to indemnify the customer for personal injury or property damage caused by the Company's products and services. Indemnification is typically limited to replacement of the items or the actual price of the products and services. The Company maintains product liability insurance as well as errors and omissions insurance, which may provide a source of recovery in the event of an indemnification claim, but does not maintain insurance coverage for claims related to intellectual property rights.

Historically, any amounts payable under these indemnifications have not had a material effect on the Company's business, financial condition, results of operations, or cash flows. The Company has not recorded any provision for future obligations under these indemnifications. If the Company determines it is probable that a loss has occurred under these indemnifications, then any such reasonably estimable loss would be recognized.

Director and officer indemnities

The Company has entered into indemnification agreements with its directors and certain executive officers that require the Company to indemnify such individuals against certain expenses, judgments and fines in third-party and derivative proceedings. The Company may recover, under certain circumstances, some of the expenses and liabilities that arise in connection with such indemnifications under the terms of its directors' and officers' insurance policies. The Company has not recorded any provision for future obligations under these indemnification agreements.

Bank guarantees and letters of credit

At December 31, 2016, the Company had standby letters of credit totaling $0.9 million. If the Company fails to meet its contractual obligations, these bank guarantees and letters of credit may become liabilities of the Company. This amount consists of approximately $0.9 million of outstanding performance guarantees secured by bank guarantees under the Company's domestic credit facility. Bank guarantees arise when the Company collects customer deposits prior to order fulfillment. The customer deposits received are recorded as current liabilities on the Company's balance sheet. The bank guarantees repayment of the customer deposit in the event an order is not completed. The bank guarantee is canceled upon shipment and transfer of title. These bank guarantees arise in the normal course of the Company's business and are not deemed to expose the Company to any significant risks since they are satisfied as part of the design and manufacturing process.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Information Concerning Forward-Looking Statements

From time to time, Key Technology, Inc. (“we", "us" or "our"), through its management, may make forward-looking public statements with respect to the company regarding, among other things, expected future revenues or earnings, projections, plans, future performance, product development and commercialization, and other estimates relating to our future operations. Forward-looking statements may be included in reports filed under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), in press releases or in oral statements made with the approval of our authorized executive officers. The words or phrases “will likely result,” “are expected to,” “intends,” “is anticipated,” “estimates,” “believes,” “projects” or similar expressions are intended to identify “forward-looking statements” within the meaning of Section 21E of the Exchange Act and Section 27A of the Securities Act of 1933, as amended, as enacted by the Private Securities Litigation Reform Act of 1995.

Forward-looking statements are subject to a number of risks and uncertainties, the occurrence of any of which could cause the price of our common stock to fluctuate significantly, making it difficult for shareholders to resell common stock at a time or price they find attractive. We caution investors not to place undue reliance on our forward-looking statements, which speak only as of the date on which they are made. Our actual results may differ materially from those described in the forward-looking statements as a result of various factors, including those listed below:

- adverse changes in general economic conditions may adversely affect our customers, our business and results of operations;
- ongoing uncertainty in the global economy may adversely affect our operating results;
- variable economic conditions in the food processing industry, either globally or regionally, may adversely affect our sales;
- significant investments in unsuccessful research and development efforts could materially adversely affect our business;
- our existing and new products may not compete successfully in either current or new markets, which could result in the loss of market share and a decrease in our sales and profits;
- the loss of any of our significant customers could reduce our sales and profitability;
- competition may result in lower sales and prices for our products and services;
- consolidation by our competitors could increase competition in the food processing equipment industry, and consolidation by our food processing industry customers could increase their purchasing power, both of which could reduce our sales and profitability;
- customer sourcing initiatives and purchasing power may adversely affect our new equipment and aftermarket sales, which could result in reduced gross margins;
- our sales and profits may vary widely from quarter to quarter and year to year due to the timing, size and composition of major orders;
- our operating results are seasonal and may further fluctuate due to severe weather conditions affecting the agricultural industry in various parts of the world;
- the failure of our independent sales representatives to perform as expected could harm our net sales;
- our international operations subject us to a number of risks that could adversely affect our sales, operating results and growth;
- we have made, or may make, acquisitions or enter into distribution agreements or similar business relationships that could disrupt our operations and harm our operating results;
- fluctuations in foreign currency exchange rates could result in unanticipated losses that could adversely affect our results of operations and financial position;
- advances in technology by competitors may adversely affect our sales and profitability;
- 

our expansion into new markets, increasingly complex projects and applications, and integrated product offerings could increase our cost of operations and reduce gross margins and profitability;

- the failure of our suppliers to deliver quality products in a timely manner or our inability to obtain components for our products could adversely affect our operating results;
- our dependence on certain suppliers may leave us temporarily without adequate access to raw materials, intellectual property or products;
- the limited availability and possible cost fluctuations of materials used in our products could adversely affect our gross margins;
- our products may suffer from defects leading to warranty claims;
- information security breaches or business system disruptions may adversely affect our business;
- our potential inability to attract and retain experienced management and other key personnel, or the loss of key management personnel, may adversely affect our business and prospects for growth;
- our potential inability to protect our intellectual property, especially as we expand geographically, may adversely affect our competitive advantage;

- intellectual property-related litigation expenses and other costs resulting from infringement claims asserted against us by third parties may adversely affect our results of operations and our customer relations; and
- our financing agreements contain restrictive and financial covenants that may adversely affect us.

More information may be found in Item 1A, “Risk Factors,” in our Annual Report on Form 10-K for the fiscal year ended September 30, 2016 filed with the SEC on December 9, 2016, which item is hereby incorporated herein by reference.

Given these uncertainties, readers are cautioned not to place undue reliance on the forward-looking statements. We disclaim any obligation subsequently to revise or update forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

Overview

General

We and our operating subsidiaries design, manufacture, sell and service automation systems that process product streams of discrete pieces to improve safety and quality. These systems integrate electro-optical automated inspection and sorting systems with process systems that include specialized conveying and preparation systems. We provide parts and service for each of our product lines to customers throughout the world. Industries served include food processing, tobacco, plastics, pharmaceuticals and nutraceuticals. We maintain two domestic manufacturing facilities and two European manufacturing facilities located in Belgium and the Netherlands. We market our products directly and through independent sales representatives.

Recently, approximately half of our sales have been made to customers located outside the United States. In our export and international sales, we are subject to the risks of conducting business internationally, including unexpected changes in regulatory requirements; fluctuations in the value of the U.S. dollar, which could increase or decrease the sales prices of our products in local currencies; tariffs and other barriers and restrictions; and the burdens of complying with a variety of international laws.

The worldwide economy and economic uncertainty continue to challenge our operating results. We continue to see customers seeking to retain cash and requiring higher returns on investment, price sensitivity, longer or delayed purchasing cycles, and more purchasing decisions at corporate levels rather than local operating locations. In addition, in response to excess capacity, the market continues to see very aggressive pricing efforts to stimulate demand, which has increased price competition for our products, especially in automated inspection systems where pricing and competition are particularly aggressive.

Current Period - First quarter of fiscal 2017

Net sales of $27.4 million in the first quarter of fiscal 2017 were $2.6 million, or 10%, higher than net sales of $24.8 million in the corresponding quarter a year ago. The higher net sales in the first quarter of fiscal 2017 were primarily due to increased sales in the automated inspection systems and parts and service product lines partially offset by decreases in the process systems product lines. Net sales increased most significantly in Europe and to a lesser extent in North America. International sales were 55% of net sales for the first quarter of fiscal 2017, compared to 51% in the corresponding prior-year period. The backlog of $45.8 million at the end of the first quarter of fiscal 2017 represents an increase of $8.8 million, or 24%, over the backlog of $37.0 million at the end of the corresponding quarter a year ago. A significant portion of the ending backlog at December 31, 2016 is not expected to ship until the third quarter of fiscal 2017. As a result, net sales for the second quarter of fiscal 2017 are expected to remain relatively consistent as compared to the net sales recorded in the first quarter of fiscal 2017.

Orders in the first quarter of fiscal 2017 of $32.5 million were up $1.5 million, or 5%, compared to orders of $31.0 million in the first quarter of fiscal 2016. Orders increased primarily in automated inspection systems and parts and service product lines partially offset by decreases in the process systems product lines.

The gross margin percentage in the first quarter of fiscal 2017 was 33.7% as compared to 28.1% for the same period in the prior year. The increase was primarily due to a favorable product mix. Gross margin percentages in the second quarter of fiscal 2017 are expected to decrease moderately as compared to the percentages from the first quarter of fiscal 2017.

Operating expenses of $9.1 million decreased approximately $0.3 million, or 3%, as compared to $9.4 million for the same period in the prior year. This decrease is primarily due to the non-recurrence of $0.7 million of restructuring charges incurred in the first quarter of fiscal 2016. The decrease was partially offset by increased sales and marketing expenses due to the increase in net sales and multiple trade shows during the period, and increased research and development expenditures related to new product development. Overall operating expenses in the second quarter of fiscal 2017 are expected to be slightly lower than the expense level in the first quarter of fiscal 2017.

Overall, the Company's earnings from operations of $0.1 million in the first quarter of fiscal 2017 improved compared to losses from operations of $2.4 million in the same quarter in the prior year. The net earnings for the first quarter of fiscal 2017 were $15,000, or $0.00 per diluted share. The net loss for the corresponding three-month period in fiscal 2016 was $1.7 million, or $0.27 per diluted share. The net earnings in the most recent three-month period increased as compared to the prior year period primarily due to increased sales, improved gross margins, and lower operating expenses.

Application of Critical Accounting Policies

We have identified our critical accounting policies, the application of which may materially affect our financial statements, either because of the significance of the financial statement item to which they relate, or because they require management judgment to make estimates and assumptions in measuring, at a specific point in time, events which will be settled in the future. The critical accounting policies, judgments and estimates which management believes have the most significant effect on the financial statements are set forth below:

- Revenue recognition
- Allowances for doubtful accounts
- Valuation of inventories
- Long-lived assets
- Allowances for warranties
- Accounting for income taxes

Management has discussed the development, selection and related disclosures of these critical accounting estimates with the audit committee of our board of directors.

Revenue Recognition. We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been provided, the sale price is fixed or determinable, and collectability is reasonably assured. Additionally, we sell our goods on terms which transfer title and risk of loss at a specified location, typically shipping point, port of loading or port of discharge, depending on the final destination of the goods. Accordingly, revenue recognition from product sales occurs when all criteria are met, including transfer of title and risk of loss, which occurs either upon shipment by us or upon receipt by customers at the location specified in the terms of sale. Sales of system upgrades are recognized as revenue upon completion of the conversion of the customer's existing system when this conversion occurs at the customer site. Revenue earned from services (maintenance, installation support, and repairs) is recognized ratably over the contractual period or as the services are performed. If any contract provides for both equipment and services (multiple deliverables), the sales price is allocated to the various elements based on the relative selling price. Each element is then evaluated for revenue recognition based on the previously described criteria. We typically have a very limited number of contracts with multiple deliverables and they are not material to the financial statements. Our sales arrangements provide for no other significant post-shipment obligations.

If all conditions of revenue recognition are not met, we defer revenue recognition. In the event of revenue deferral, the sale value is not recorded as revenue to us, accounts receivable are reduced by any related amounts owed by the customer, and the cost of the goods or services deferred is carried in inventory. In addition, we periodically evaluate whether an allowance for sales returns is necessary. Historically, we have experienced few sales returns. We account for cash consideration (such as sales incentives) that are given to customers or resellers as a reduction of revenue rather than as an operating expense unless an identified benefit is received for which fair value can be reasonably estimated. We believe that revenue recognition is a "critical accounting estimate" because our terms of sale vary significantly, and management exercises judgment in determining whether to recognize or defer revenue based on those terms. Such judgments may materially affect net sales for any period. Management exercises judgment within the parameters of GAAP in determining when contractual obligations are met, title and risk of loss are transferred, the sales price is fixed or determinable and collectability is reasonably assured. At December 31, 2016, we had invoiced $1.0 million, compared to $1.7 million at September 30, 2016, for which we have not recognized revenue.

Allowances for doubtful accounts. We establish allowances for doubtful accounts for specifically identified, as well as anticipated, doubtful accounts based on credit profiles of customers, current economic trends, contractual terms and conditions, and customers' historical payment patterns. Factors that affect collectability of receivables include general economic or political factors in certain countries that affect the ability of customers to meet current obligations. We actively manage our credit risk by utilizing an independent credit rating and reporting service, by requiring certain percentages of down payments, and by requiring secured forms of payment for customers with uncertain credit profiles or located in certain countries. Forms of secured payment could include irrevocable letters of credit, bank guarantees, third-party leasing arrangements or EX-IM Bank guarantees, each utilizing Uniform Commercial Code filings, or the like, with governmental entities where possible. We believe that the accounting estimate related to allowances for doubtful accounts is a "critical accounting estimate" because it requires management judgment in making assumptions relative to customer or general economic factors that are outside our control. As of December 31, 2016, the balance sheet included allowances for doubtful accounts of $256,000 as compared to $266,000 at September 30, 2016. Amounts charged to bad debt expense for the three months ended December 31, 2016 and 2015, respectively, were $0 and $5,000. Actual charges to the allowance for doubtful accounts for the three months ended December 31, 2016 and 2015, respectively, were $0 and $9,000. If we experience actual bad debt expense in excess of estimates, or if estimates are adversely adjusted in future periods, the carrying value of accounts receivable will decrease and charges for bad debts will increase, resulting in decreased net earnings.

Valuation of inventories. Inventories are stated at the lower of cost or market. Our inventory includes purchased raw materials, manufactured components, purchased components, service and repair parts, work in process, finished goods and demonstration equipment. Write downs for excess and obsolete inventories are made after periodic evaluation of historical sales, current economic trends, forecasted sales, estimated product lifecycles and estimated inventory levels. The factors that contribute to inventory valuation risks are our purchasing practices, electronic component obsolescence, accuracy of sales and production forecasts, introduction of new products, product lifecycles and the associated product support. We actively manage our exposure to inventory valuation risks by maintaining low safety stocks and minimum purchase lots, utilizing just-in-time purchasing practices, managing product end-of-life issues brought on by aging components or new product introductions, and by utilizing inventory minimization strategies such as vendor-managed inventories. We believe that the accounting estimate related to valuation of inventories is a "critical accounting estimate" because it is susceptible to changes from period to period due to the requirement for management to make estimates relative to each of the underlying factors ranging from purchasing to sales to production to after-sale support. At December 31, 2016, cumulative inventory adjustments to the lower of cost or market totaled $5.1 million, compared to $4.3 million at December 31, 2015. Amounts charged to expense to record inventory at lower of cost or market for the three months ending December 31, 2016 and 2015 were $358,000 and $222,000, respectively. Actual charges to the cumulative inventory adjustments upon disposition or sale of inventory were $106,000 and $119,000 for the three months ending December 31, 2016 and 2015, respectively. If actual demand, market conditions or product lifecycles are adversely different from those estimated by management, inventory adjustments to lower market values will result in a reduction to the carrying value of inventory, an increase in inventory write-offs, and a decrease to gross margins.

Long-lived assets. We regularly review all of our long-lived assets, including property, plant and equipment, and amortizable intangible assets, for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. If the total of projected future undiscounted cash flows is less than the carrying amount of these assets, an impairment loss based on the excess of the carrying amount over the fair value of the assets is recorded. In addition, goodwill is reviewed based on its fair value at least annually. As of December 31, 2016, we held $28.9 million of long-lived assets, net of depreciation and amortization. There were no material changes during the quarter that would result in an adjustment of the carrying value for these assets. Estimates of future cash flows arising from the utilization of these long-lived assets and estimated useful lives associated with the assets are critical to the assessment of their recoverability and fair values. We believe that the accounting estimate related to long-lived assets is a "critical accounting estimate" because: (1) it is susceptible to change from period-to-period due to the requirement for management to make assumptions about future sales and cost of sales generated throughout the lives of several product lines over extended periods of time; and (2) the potential effect that recognizing an impairment could have on the assets reported on our balance sheet and the potential material adverse effect on reported earnings or loss. Changes in these estimates could result in a determination of asset impairment, which would result in a reduction to the carrying value and a reduction to net earnings in the affected period.

Allowances for warranties. Our products are covered by standard warranty plans included in the price of the products ranging from 90 days to five years, depending upon the product and contractual terms of sale. The majority of the warranty periods are for one year or less. We establish allowances for warranties for specifically identified, as well as anticipated, warranty claims based on contractual terms, product conditions and actual warranty experience by product line. Our products include both manufactured and purchased components and, therefore, warranty plans include third-party sourced parts which may not be covered by the third-party manufacturer's warranty. We actively manage our quality program by using a structured product introduction plan, process monitoring techniques utilizing statistical process controls, vendor quality metrics, and feedback loops to communicate warranty claims to designers and engineers for remediation in future production. We believe that the accounting estimate related to allowances for warranties is a "critical accounting estimate" because: (1) it is susceptible to significant fluctuation period-to-period due to the requirement for management to make assumptions about future warranty claims relative to potential unknown issues arising in both existing and new products, which assumptions are derived from historical trends of known or resolved issues; and (2) risks associated with third-party supplied components being manufactured using processes that we do not control. As of December 31, 2016, the balance sheet included warranty reserves of $1.7 million. Warranty charges of $0.6 million were incurred during the three-month period then ended. Warranty reserves were $2.1 million as of December 31, 2015 and warranty charges of $0.7 million were incurred during the three-month period then ended. If our actual warranty costs are higher than estimates, future warranty plan coverages are different, or estimates are adversely adjusted in future periods, reserves for warranty expense will need to increase, warranty expense will increase and gross margins will decrease.

Accounting for income taxes. Our provision for income taxes and the determination of the resulting deferred tax assets and liabilities involves a significant amount of management judgment. The quarterly provision for income taxes is based partially upon estimates of pre-tax financial accounting income for the full year and is affected by various differences between financial accounting income and taxable income. Judgment is also applied in determining whether the deferred tax assets will be realized in full or in part. In management’s judgment, when it is more likely than not that all or some portion of specific deferred tax assets will not be realized, a valuation allowance must be established for the amount of the deferred tax assets that are determined not to be realizable. At December 31, 2016, we had valuation reserves of approximately $197,000 for deferred tax assets for capital loss carryforwards and changes in the carrying value of our investment in Proditec, and offsetting amounts for foreign deferred tax assets and U.S. deferred tax liabilities, primarily related to net operating loss carryforwards in the foreign jurisdictions that we believe will not be utilized during the carryforward periods. During the three months ended December 31, 2016, there was no change in our valuation reserves. There were no other material valuation allowances at December 31, 2016 due to anticipated utilization of all the deferred tax assets as we believe we will have sufficient taxable income to utilize these assets. We maintain reserves for uncertain tax positions in jurisdictions of operation. These tax jurisdictions include federal, state and various international tax jurisdictions. Potential income tax exposures include potential challenges of various tax credits and deductions, and issues specific to state and local tax jurisdictions. Exposures are typically settled primarily through audits within these tax jurisdictions, but can also be affected by changes in applicable tax law or other factors, which could cause our management to believe a revision of past estimates is appropriate. Thus far, during fiscal 2017, there have been no significant changes in these estimates. Management believes that an appropriate liability has been established for estimated exposures; however, actual results may differ materially from these estimates. We believe that the accounting estimate related to income taxes is a “critical accounting estimate” because it relies on significant management judgment in making assumptions relative to temporary and permanent timing differences of tax effects, estimates of future earnings, prospective application of changing tax laws in multiple jurisdictions, and the resulting ability to utilize tax assets at those future dates. If our operating results were to fall short of expectations, thereby affecting the likelihood of realizing the deferred tax assets, judgment would have to be applied to determine the amount of the valuation allowance required to be included in the financial statements in any given period. Establishing or increasing a valuation allowance would reduce the carrying value of the deferred tax asset, increase tax expense and reduce net earnings.

During the first quarter of fiscal 2016, the research and development tax credit was permanently renewed retroactive to January 1, 2015. In the first quarter of fiscal 2016, income tax expense was reduced by approximately $106,000 for additional research and development tax credits related to expenditures incurred during fiscal 2015 due to the renewal of this tax credit.

Recent Accounting Pronouncements Not Yet Adopted.

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standard Update (“ASU”) 2014-09, “Revenue from Contracts with Customers” (“ASU 2014-09”). ASU 2014-09 supersedes nearly all existing revenue recognition guidance under GAAP. The standard’s core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the Company expects to be entitled in exchange for those goods or services. We are evaluating our existing revenue recognition policies to determine whether any contracts in the scope of the guidance will be affected by the new requirements. ASU 2014-09, as amended by ASU 2015-14, is effective for annual reporting periods beginning after December 15, 2017, including interim periods therein.

In July 2015, the FASB issued ASU 2015-11, "Simplifying the Measurement of Inventory" ("ASU 2015-11"). The previous standard required entities to measure inventory at the lower of cost or market, with market defined as net realizable value or replacement cost. ASU 2015-11 requires entities to measure inventory at the lower of cost and net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. ASU 2015-11 is effective for annual reporting periods beginning after December 15, 2016, including interim periods therein. The Company does not anticipate that it will have a material effect on its financial statements.

In November 2015, the FASB issued ASU 2015-17, "Balance Sheet Classification of Deferred Taxes," which eliminates the current requirement to present deferred tax liabilities and assets as current and non-current in a classified balance sheet. Instead, entities will be required to classify all deferred tax assets and liabilities as non-current. This ASU will be effective for the Company beginning in its first quarter of fiscal year 2018 and may be adopted prospectively or retrospectively. Early adoption is permitted but the Company has not elected to do so. The Company does not expect its adoption to have a material effect on its financial statements.

In February 2016, the FASB issued ASU 2016-02, "Leases" (“ASU 2016-02”), which is intended to improve financial reporting about leasing transactions. ASU 2016-02 will require lessees to recognize the assets and liabilities for the rights and obligations created by those leases on their balance sheet. Lessees will be required to recognize assets and liabilities for leases with lease terms of more than 12 months. ASU 2016-02 is effective for public companies for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted. The Company has not yet determined the effect that adoption of ASU 2016-02 will have on its consolidated financial position and consolidated results of operations.

In March 2016, the FASB issued ASU 2016-09, "Stock Compensation," which is intended to simplify several aspects of the accounting for share-based payment award transactions, including adjustments to the timing of when excess tax benefits should be recorded and classification in the statement of cash flows. The guidance will be effective for fiscal years beginning after December 15, 2016, including interim periods within those years. The Company does not anticipate that the adoption of this ASU will materially impact its results of operations.

Results of Operations

For the three months ended December 31, 2016 and 2015

Net sales increased $2.6 million, or 10%, to $27.4 million in the first quarter of fiscal 2017 from $24.8 million recorded in the corresponding quarter a year ago. International sales for the three-month period ending December 31, 2016 were 55% of net sales, compared to 51% in the corresponding prior year period. The increase in net sales occurred primarily in Europe and to a lesser extent in North America. Net sales increased most significantly in the potato market. Automated inspection systems net sales were up $3.2 million, or 42%, to $11.0 million due primarily to the timing of shipments. The increase in automated inspection system sales was in belt-fed, chute-fed, and upgrade products. Net sales of process systems decreased $1.2 million, or 11%, to $9.5 million in the first quarter of fiscal 2017. This decrease was across most process system product types. Parts and service sales were $6.8 million, up $0.5 million or 8%. Automated inspection systems sales, including upgrade systems, represented 40% of net sales in the first quarter of fiscal 2017 compared to 31% of net sales in the first quarter of fiscal 2016. Process systems sales represented 35% of net sales in the first quarter of fiscal 2017 compared to 43% during the first quarter of fiscal 2016, while parts and service sales accounted for 25% of net sales in the first quarter of fiscal 2017, compared to 26% during the first quarter of fiscal 2016. We expect net sales in the second quarter of fiscal 2017 to remain relatively consistent as compared to the net sales reported in the first quarter of fiscal 2017 due to a significant portion of the beginning backlog that is not expected to ship until the third quarter of fiscal 2017.

Total backlog was $45.8 million at the end of the first quarter of fiscal 2017, which was $8.8 million, or 24%, higher than the $37.0 million backlog at the end of the first quarter of the prior fiscal year. Automated inspection systems backlog increased by $4.3 million, or 26%, to $21.4 million at the end of the first quarter of fiscal 2017 compared to $17.1 million at the same time a year ago. The increase was primarily in belt-fed products. Backlog for process systems was up $4.0 million, or 22%, to $22.2 million at December 31, 2016 compared to $18.2 million at December 31, 2015, and was up across most product types. Backlog by product line at December 31, 2016 was 47% automated inspection systems, 48% process systems, and 5% parts and service, as compared to 46% automated inspection systems, 49% process systems, and 5% parts and service at December 31, 2015.

Orders of $32.5 million in the first quarter of fiscal 2017 were $1.5 million, or 5%, higher than the first quarter new orders of $31.0 million a year ago. Automated inspection systems orders increased $2.0 million, or 21%, during the first quarter of fiscal 2017 to $11.3 million compared to $9.3 million in the first quarter of fiscal 2016. Orders for automation inspection systems increased primarily for upgrades and ADR product types. Orders for process systems during the first quarter of fiscal 2017 decreased $1.9 million, or 12%, to $13.9 million from $15.8 million in the comparable quarter of fiscal 2016. The decrease in orders for process systems occurred across most product types. Orders for parts and service were $7.3 million, or 24% higher than the first quarter of fiscal 2016 of $5.9 million. Orders overall were up primarily in Europe, partially offset by decreases in North America.

Gross profit for the first quarter of fiscal 2017 was $9.2 million, compared to $7.0 million in the corresponding period last year. Gross margin in the first quarter of fiscal 2017, as a percentage of net sales, increased to 33.7% compared to the 28.1% reported in the corresponding quarter of fiscal 2016. The gross margin percentage for the first quarter of fiscal 2017 was higher primarily due to a more favorable product mix. We anticipate the gross margin percentage in the second quarter of fiscal 2017 will decrease moderately as compared to the percentage from the first quarter of fiscal 2017.

Operating expenses of $9.1 million for the first quarter of fiscal 2017 were 33.4% of net sales compared to $9.4 million for the first quarter of fiscal 2016 and 37.8% of net sales. The decrease in operating expenses related primarily to the non-recurrence of $0.7 million of restructuring charges incurred in the first quarter of 2016. The decrease was partially offset by increased sales and marketing expenses due to the increases in net sales and multiple trade shows during the period, and increased research and development expenditures associated with new product development. Total operating expenses in the second quarter of fiscal 2017 are expected to be slightly lower than expense levels in the first quarter of fiscal 2017.

Other expense for the first quarter of fiscal 2017 was $78,000, compared to $339,000, for the corresponding period in fiscal 2016 and decreased primarily due to foreign exchange gains in the first quarter of fiscal 2017 as compared to the prior year's first fiscal quarter.

The net earnings for the quarter ended December 31, 2016 were $15,000, or $0.00 per diluted share. The net loss for the corresponding period last year was $1.7 million, or $0.27 per diluted share. The increase in net earnings in the first quarter of fiscal 2017 compared to the net earnings in the first quarter of fiscal 2016 was primarily the result of higher net sales and resulting higher gross profits, and lower operating expenses.

Liquidity and Capital Resources

In the first three months of fiscal 2017, net cash decreased by $3.3 million to $7.2 million on December 31, 2016 from $10.5 million on September 30, 2016. Cash used in operating activities was $2.4 million during the three months ended December 31, 2016. Investing activities consumed $0.4 million of cash. Financing activities provided $0.4 million of cash.

Cash used in operating activities during the three months ended December 31, 2016 was $2.4 million. For the first three months of fiscal 2017, net earnings were $15,000. Non-cash items included in the net earnings in the first three months of fiscal 2017, such as depreciation, amortization, deferred taxes and share-based compensation, were approximately $1.2 million. In the first three months of fiscal 2017, changes in non-cash working capital used $3.6 million of cash in operating activities. The major changes in current assets and liabilities using cash during the first three months of fiscal 2017 were increases in inventory of $3.9 million due to the increased backlog and production, increases in accounts receivable of $2.7 million due to the increase in net sales, and the timing of shipments and related collections. These uses were partially offset by increases in customer deposits of $1.8 million due to the increased backlog and timing of collections and shipments, and increases in accounts payable of $1.5 million due to increased production and the timing of payments.

For the first three months of fiscal 2016, $0.7 million of cash was used in operating activities, composed of a net loss of $1.7 million; non-cash items such as depreciation, amortization, deferred taxes and share-based compensation included in the net loss were $1.2 million; and changes in non-cash working capital used $0.2 million. The primary changes in the first three months of fiscal 2017 as compared to the first three months of fiscal 2016 were the decreased net loss and increases in cash used for working capital. Significant changes in working capital included increased use of cash for inventory and increased accounts receivable, and a decrease in cash used for accounts payable.

Net cash used in investing activities was $0.4 million for the first three months of fiscal 2017 compared to $0.2 million for the first three months of fiscal 2016. Cash used for investing activities in the fiscal 2017 period related entirely to capital expenditures.

Net cash provided by financing activities during the first three months of fiscal 2017 was $366,000, compared with net cash used in financing activities of $413,000 during the corresponding period in fiscal 2016. Net cash used in financing activities during the first three months of fiscal 2017 primarily resulted from $163,000 of repayments of long-term debt, and $212,000 of payroll taxes paid in connection with stock surrenders related to compensatory stock awards, partially offset by $9,000 of proceeds from the issuance of common stock. Cash used in financing activities during the first three months of fiscal 2016 resulted mainly from payments on long-term debt of $177,000 and payroll taxes of $254,000 paid in connection with stock surrenders related to compensatory stock awards, partially offset by $13,000 of proceeds from the issuance of common stock.

The Company's domestic credit facility provides for a maximum of $20.3 million consisting of a three-year term loan of $5.3 million and revolving loans up to the lesser of $15.0 million or a borrowing base calculated based on the outstanding amount of the Company's eligible accounts receivable and eligible inventory. The credit facility also provides for a credit sub-facility of up to $4.0 million for standby letters of credit. The credit facility matures on July 19, 2018. The revolving credit facility bears interest, at the Company's option, at either the lender's base lending rate or LIBOR using a tiered structure depending on the Company's achievement of a specified financial ratio. The Company's base lending rate option is the lender's base lending rate plus 0.75%, 1.00% or 1.25% per annum. The Company's LIBOR option is LIBOR plus 2.25%, 2.50% or 2.75%. At December 31, 2016, the interest rate would have been 3.02% based on the lowest of the available alternative rates. The term loan bears interest, at the Company's option, at either the lender's base lending rate plus 1.75% or the one-, two-, or three-month LIBOR rate plus 3.25%. The Company also simultaneously entered into an interest rate swap agreement with the lender to fix the term loan interest rate at 6.20%. The credit facility is secured by the Company's receivables, equipment and fixtures, inventory, general intangibles, subsidiary stock, securities, investment property, financial assets, real property, and certain other assets. The credit facility contains covenants related to minimum liquidity levels and certain financial covenants that will be applicable only if the Company does not exceed certain calculated total unrestricted cash and credit availability or an event of default occurs. The credit facility permits capital expenditures to a certain level and contains customary default and acceleration provisions. The credit facility also restricts, above certain levels, acquisitions, incurrence of additional indebtedness, payment of dividends and lease expenditures. At December 31, 2016, the Company had no outstanding borrowings under the revolving line of credit and $0.9 million of outstanding standby letters of credit.

The Company's Belgian subsidiary has a credit accommodation with a commercial bank in Belgium. This credit accommodation totals €2.7 million ($2.8 million) and includes an operating line of €800,000 ($0.8 million), a bank guarantee facility of €500,000 ($0.5 million), and loan agreement provisions of €1.4 million ($1.5 million). The operating line and bank guarantee facility are secured by all of the subsidiary's current assets. The Belgian operating line bears interest at the bank's prime rate plus 1.25%. At December 31, 2016, the interest rate was 9.75%. At December 31, 2016, the subsidiary had no borrowings under the operating line. At December 31, 2016, the subsidiary had various loans outstanding under the loan agreement provisions totaling €165,000 ($174,000). The fixed interest rates on these loans ranged from 3.68% to 3.98%. The loans mature between February 2017 and November 2017. At December 31, 2016, the subsidiary had no bank guarantees outstanding under the bank guarantee facility.

Our continuing contractual obligations and commercial commitments existing on December 31, 2016 are as follows:

| | | Payments due by period (in thousands) | | | |
|---|---|---|---|---|---|
| Contractual Obligations [1] | Total | Less than 1 year | 1 – 3 years | 4 – 5 years | After 5 years |
| Long-term debt | $4,973 | $527 | $4,446 | $— | $— |
| Interest on long-term debt [2] | 560 | 291 | 269 | — | — |
| Operating leases | 4,688 | 1,221 | 2,032 | 860 | 575 |
| Purchase obligations [3] | 316 | 316 | — | — | — |
| Total contractual cash obligations | $10,537 | $2,355 | $6,747 | $860 | $575 |

(1) We also have $92,000 of contractual obligations related to uncertain tax positions for which the timing and amount of payment cannot be reasonably estimated due to the nature of the uncertainties and the unpredictability of jurisdictional examinations in relation to the statute of limitations.

(2) Includes the effect of the interest-rate swap agreement that fixed the interest rate at 6.20%.

(3) Purchase obligations are commitments to purchase certain materials, supplies and services which will be used in the ordinary course of business.

We anticipate that current cash balances, ongoing cash flows from operations, and borrowing capacity under currently available operating credit lines will be sufficient to fund our operating needs for the foreseeable future. At December 31, 2016, we had standby letters of credit totaling $0.9 million, which includes secured bank guarantees under our domestic credit facility. If we fail to meet our contractual obligations, these bank guarantees and letters of credit may become our liabilities.  We have no off-balance sheet arrangements or transactions, or arrangements or relationships with “special purpose entities.”

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Foreign Currency Exchange Risk. We have assessed our exposure to market risks for our financial instruments and have determined that our exposure to such risks is generally limited to those affected by the value of the U.S. dollar compared to the Euro and to a lesser extent the Australian dollar and Mexican peso.

The terms of sales to European customers are typically denominated in Euros. We expect that our standard terms of sale to international customers, other than those in Europe, will continue to be denominated in U.S. dollars, although as we expand our international operations, transactions denominated in the local currencies of these countries may increase. As of December 31, 2016, management estimates that a 10% change in foreign exchange rates would affect net earnings before taxes by approximately $219,000 on an annual basis as a result of the conversion to U.S. dollars of cash, accounts receivable, loans to foreign subsidiaries, and sales or other contracts denominated in foreign currencies. These changes would positively affect net earnings if the U.S. dollar weakens on world markets and negatively affect net earnings if the U.S. dollar strengthens on world markets. We assess our currency exchange risk on an on-going basis and may enter into forward contracts to minimize such risk. At December 31, 2016, we held a 30-day forward contract for €3.5 million ($3.7 million).

As of December 31, 2016, the U.S. dollar gained approximately 7% in value against the Euro compared to its value at September 30, 2016. During the three month period ended December 31, 2016, changes in the value of the U.S dollar against the Euro ranged between a 3% gain and a 7% gain as compared to the value at September 30, 2016. The U.S. dollar also gained in value against our other relevant foreign currencies during the first three months of fiscal 2017. The effect of these fluctuations on our operations and financial results during the three months ended December 31, 2016 were:

- Translation adjustments of ($0.9) million, net of income tax, were recognized as a component of comprehensive income as a result of converting the Euro-denominated balance sheets of our European subsidiaries into U.S. dollars and, to a lesser extent, the Australian dollar balance sheet of our Australian subsidiary, and the Peso balance sheets of our Mexican subsidiaries.

- Foreign exchange gains of $75,000, net of the effects of forward exchange contracts settled during the period, were recognized in the other income and expense section of the consolidated statement of operations as a result of conversion of Euro and other foreign currency denominated receivables, intercompany loans, and cash carried on the balance sheet of the U.S. operations, as well as the result of the conversion of other non-functional currency receivables, payables and cash carried on the balance sheets of the European, Australian, and Mexican operations.

When the U.S. dollar strengthens on the world markets, our market and economic outlook for international sales could be negatively affected as products sold to international customers become relatively more expensive to those customers. Conversely, a relatively weaker U.S. dollar makes our U.S.-manufactured goods less expensive to international customers when denominated in U.S. dollars or potentially less profitable to us when denominated in a foreign currency. On the other hand, materials or components imported into the U.S. may be more expensive. Our Netherlands-based subsidiary transacts business primarily in Euros and does not have significant exports to the U.S., but does import a significant portion of its products from its U.S.-based parent company. These imports from the U.S. are expected to decrease in the near future. Our Belgian-based subsidiary also transacts business primarily in Euros and has significant exports to the U.S.-based parent company which are also expected to decrease in the near future.

Interest Rate Risk. Under our domestic credit facility, we are able to borrow at either (a) the lender’s prime rate plus 75, 100 or 125 basis points or (b) at LIBOR plus 225, 250 or 275 basis points depending on our achievement of a specified financial ratio. Our Belgian subsidiary may borrow on our Belgian credit facility at the lender's prime rate plus 1.25%. At December 31, 2016, we had no borrowings under these arrangements. During the three months ended

December 31, 2016, interest rates applicable to these variable rate credit facilities ranged from 3.02% to 9.75% based on the lowest of the available alternative rates. At December 31, 2016, the rate would have been 3.02% on our domestic credit facility and would have been 9.75% on our Belgian credit facility. The term loan on our headquarters building bears interest, at the Company's option, at the lender's base rate plus 175 basis points or the one-, two- or three-month LIBOR rate plus 325 basis points, but we simultaneously entered into an interest rate swap agreement with the lender to fix the interest rate at 6.20%. Long-term fixed-rate borrowings at our Belgian subsidiary bear interest at rates ranging from 3.68% to 3.98%. As of December 31, 2016, management estimates that a 100 basis point change in these interest rates would not affect net income before taxes because we had no borrowings outstanding under our variable interest rate credit facilities and the interest rate swap effectively converts our variable rate term loan facility into a fixed rate facility.

## ITEM 4. CONTROLS AND PROCEDURES

Our management, with the participation of our President and Chief Executive Officer, and Senior Vice President and Chief Financial Officer, has evaluated our disclosure controls and procedures at December 31, 2016 and concluded that such controls and procedures were effective to provide reasonable assurance that information required to be disclosed in our reports filed or submitted by us under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to our management, including our President and Chief Executive Officer, and Senior Vice President and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. There were no changes in our internal control over financial reporting during the quarter ended December 31, 2016 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

The following table provides information about purchases made by us or on our behalf during the quarter ended December 31, 2016 of equity securities registered by us under Section 12 of the Exchange Act.

Issuer Purchases of Equity Securities

| Period | Total Number of Shares Purchased (1) | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| October 1-31, 2016 | 9,026 | $ 11.00 | — | |
| November 1-30, 2016 | — | — | — | |
| December 1-31, 2016 | 9,776 | $ 11.57 | — | |
| Total | 18,802 | $ 11.30 | — | 429,202 (2) |

(1) Includes shares of restricted stock surrendered to satisfy tax withholding obligations by plan participants under our employee stock incentive plan. The shares were subsequently canceled.

(2) We initiated a new stock repurchase plan effective May 30, 2012. We were authorized to repurchase up to 500,000 shares of our common stock under the program. The timing of any repurchases and the exact number of shares of common stock to be purchased will be determined by us and will depend on market conditions and other factors. The program does not incorporate a fixed expiration date.

ITEM 6. EXHIBITS

| | |
|---|---|
| 31.1 | Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 101 | The following materials from Key Technology, Inc.'s Quarterly Report on Form 10-Q for the quarter ended December 31, 2016, formatted in XBRL (eXtensible Business Reporting Language): (i) Unaudited Condensed Consolidated Balance Sheets at December 31, 2016 and December 31, 2015, (ii) Unaudited Condensed Consolidated Statements of Operations for the three months ended December 31, 2016 and 2015, (iii) Unaudited Condensed Consolidated Statements of Comprehensive Income for the three months ended December 31, 2016 and 2015, (iv) Unaudited Condensed Consolidated Statements of Cash Flows for the three months ended December 31, 2016 and 2015, and (v) Notes to Unaudited Condensed Consolidated Financial Statements for the three months ended December 31, 2016. |

## 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.

| | | |
|---|---|---|
| | | KEY TECHNOLOGY, INC.<br>(Registrant) |
| Date: | February 3, 2017 | By /s/ John J. Ehren<br>John J. Ehren<br>President and Chief Executive Officer |
| Date: | February 3, 2017 | By /s/ Jeffrey T. Siegal<br>Jeffrey T. Siegal<br>Senior Vice President and Chief Financial Officer |

EXHIBIT INDEX

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