KEITHLEY INSTRUMENTS INC
Form 10-K
December 29, 2006

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

FORM 10-K
ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For fiscal year ended, SEPTEMBER 30, 2006 **Commission File Number 1-9965**
KEITHLEY INSTRUMENTS, INC.
(Exact name of registrant as specified in its charter)

Ohio	**34-0794417**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

Address of principal executive offices: **28775 Aurora Road, Solon, Ohio, 44139**
Registrant s telephone number, including area code: **(440) 248-0400**
Securities registered pursuant to section 12(b) of the Act:

Common Shares, Without Par Value	**New York Stock Exchange**
(Title of Each Class)	(Name of Each Exchange on Which Registered)

Securities Registered pursuant to section 12(g) of the Act: **None**
Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes o No þ
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 þ No o
Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer o Accelerated filer þ Non-accelerated filer o
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No þ
The aggregate market value of the Common Shares of the Registrant held by non-affiliates was $215.8 million and the aggregate market value of the Class B Common Shares of the Registrant held by non-affiliates was $0.3 million for a total aggregate market value of all classes of Common Shares held by non-affiliates of $216.1 million at March 31, 2006, the registrant s most recently completed second fiscal quarter. While the Class B Common Shares are not listed for public trading on any exchange or market system, shares of that class are convertible into Common Shares at any time on a share-for-share basis. The market values indicated were calculated based upon the last sale price of the Common Shares as reported by the New York Stock Exchange on March 31, 2006, which was $15.36.
As of December 21, 2006 there were outstanding 14,004,745 Common Shares (net of shares repurchased held in treasury), without par value, and 2,150,502 Class B Common Shares, without par value.
DOCUMENTS INCORPORATED BY REFERENCE
Portions of the registrant s Proxy Statement for the registrant s 2007 Annual Meeting of Shareholders (the 2007 Annual Meeting) are incorporated by reference in Part III in this Annual Report on Form 10-K (this Annual Report) and are

identified under the appropriate items in this Annual Report.

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Forward-Looking Statements

Statements and information included in this Annual Report on Form 10-K by Keithley Instruments, Inc. (Keithley, the Company, we, us or our) that are not purely historical are forward-looking statements within the safe harbor provisions of the Private Securities Litigation Reform Act of 1995.

Forward-looking statements in this Annual Report on Form 10-K include statements regarding Keithley s expectations, intentions, beliefs, and strategies regarding the future, including recent trends, cyclicality, and growth in the markets Keithley sells into, conditions of the electronics industry, deployment of our own sales employees throughout the world, investments to develop new products, the potential impact of adopting new accounting pronouncements, our future effective tax rate, liquidity position, ability to generate cash, expected growth, obligations under our retirement benefit plans, and the consequences of investigations and litigation related to our stock option practices.

When used in this report, the words believes, expects, anticipates, intends, assumes, estimates, evaluates, forecasts, may, could, future, forward, potential, probable, and similar expressions are intended to identify forward-looking statements.

These forward-looking statements involve risks and uncertainties. We may make other forward-looking statements from time to time, including in press releases and public conference calls and webcasts. All forward-looking statements made by Keithley are based on information available to us at the time the statements are made, and we assume no obligation to update any forward-looking statements. It is important to note that actual results are subject to a number of risks and uncertainties that could cause actual results to differ materially from those included in such forward-looking statements. Some of these risks and uncertainties are discussed below in Item 1A Risk Factors of Part I of this Form 10-K.

PART I

ITEM 1 BUSINESS

General

Keithley Instruments, Inc. was founded in 1946 and organized as an Ohio corporation in 1955. Its principal executive offices are located at 28775 Aurora Road, Solon, Ohio 44139; telephone (440) 248-0400. References herein to the Company, Keithley, we or our are to Keithley Instruments, Inc. and its subsidiaries unless the context indicates otherwise.

Our website is www.keithley.com. We make our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed with or furnished to the U.S. Securities and Exchange Commission (the SEC) available to the public free of charge through our website as soon as reasonably practicable after making such filings. The public may read and copy any materials we file with the SEC at the SEC s Public Reference Room at 100 F Street, NE, Washington, DC 20549. The public may also obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. Additionally, the SEC maintains an internet site (http://www.sec.gov) that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC.

Keithley Instruments, Inc. designs, develops, manufactures and markets complex electronic instruments and systems geared to the specialized needs of electronics manufacturers for high-performance production testing, process monitoring, product development and research. The Company has approximately 500 products used to source, measure, connect, control or communicate direct current (DC), radio frequency (RF) or optical signals. Product offerings include integrated systems solutions, along with instruments and personal computer (PC) plug-in boards that can be used as system components or stand-alone solutions. Our customers are engineers, technicians and scientists in manufacturing, product development and research functions.

During fiscal 2006, approximately 35 percent of our orders were received from the semiconductor industry; approximately 15 percent came from research and education customers; approximately 10 percent came from the wireless communications customer group; and approximately 30 percent came from the precision electronic components and subassembly manufacturers customer group, which includes customers in automotive, computers and peripherals, medical equipment, aerospace and defense, and manufacturers of components, including optoelectronic components. The remainder of orders came from customers in a variety of other industries. Although our products vary in capability, sophistication, use, size and price, they generally test, measure and analyze electrical, RF, optical or physical properties. As such, we consider our business to be in a single industry segment.

Business Strategy

We have focused our efforts on identifying test applications within segments of the electronics test and measurement industry that have high rates of technology change, long-term growth in demand, a meaningful market size, and that leverage our measurement capabilities and/or other test applications. We estimate total annual sales for these segments to be in excess of $1 billion. New products are an important factor in our sales growth strategy, and we have increased our investment in product development activity spending levels to expand our product offering and accelerate the introduction of new products. Expanding our measurement technology platforms beyond our traditional DC and IV base to include new RF and pulse test platforms allows us to serve a broader set of applications in a larger addressable market.

We work closely with our customers to build partnerships in order to anticipate their current and future measurement needs. A thorough understanding of their applications coupled with our precision measurement technology enables us to add value to our customers processes improving the quality, throughput and yield of their products, as well as to determine which test applications we will choose to serve. We believe our ability to serve our customers has been aided immeasurably by deploying our own sales and support employees throughout the Americas, Europe and Asia, as opposed to relying on a contract sales force.

We leverage our applications expertise and product platforms to other industries. By concentrating on interrelated industries and product technologies, we are able to gain insight into measurement problems experienced by one set of customers that can be addressed and offered as solutions for others. Our applications knowledge and technology solutions in one area build credibility as we expand to related fields, often using the same measurement platforms that are proven among a variety of customers.

Product Offerings

We have approximately 500 products used to source, measure, connect, control or communicate DC, RF or optical signals. Product offerings include integrated systems solutions and instruments and PC plug-in boards that can be used as system components or stand-alone solutions. Prices per product vary. Parametric test systems used by semiconductor wafer manufacturers generally range in price from $150,000 to $500,000 depending upon the options chosen by the customer. Our semiconductor characterization system ranges in price from $30,000 to $75,000. Bench top instruments generally range in price from $1,000 to $15,000 on a stand-alone basis and from $15,000 to $25,000 when used as a system. Switch systems generally range in price from $2,000 to $50,000. PC plug-in boards are used for process control and data collection applications, and in production test for machine builders and system integrators. Selling prices generally range from $200 to $4,000.

New Products During Fiscal Year 2006

The Company develops new products for specific industry applications and for general purposes to serve a larger customer constituency. New products introduced during fiscal 2006 included:

The first products in our new RF family, the Model 2910 RF Vector Signal Generator, the Model 2810 RF Vector Signal Analyzer and the Model 3500 Portable RF Power Meter. Interest in these products comes from RF Integrated Circuit (RFIC) manufacturers as well as cell phone handset manufacturers. These instruments employ new approaches to test and measurement that enable users to save time, effort and money through their ease of use, flexibility, high-performance and compact size. Our new RF products can be used throughout our customers design, development and manufacturing processes, and they complement existing Keithley solutions such as our battery simulation sources, semiconductor characterization systems, and source-measure units.

We introduced two additions to our Series 2600 System Source Meter Instruments line. The Models 2611 and 2612 add higher voltage and current pulse capabilities, which broaden the range of devices that can be tested with the high throughput and multi-channel capability of this product family. The measurement speed and functionality of these products lowers the cost of test for a wide range of semiconductor devices, sensors and other components in both lab and production applications.

For semiconductor devices and materials that require high speed pulse characterization, such as silicon on insulator based devices, we introduced the first products in our Series 3400 Pulse/Pattern Generator family, the Models 3401 and 3402. The three nanosecond pulse width of these products is ideal for semiconductor device and materials research and characterization, which includes nanotechnology R&D.

Geographic Markets and Distribution

During fiscal 2006, substantially all of the Company s products were manufactured in Ohio and were sold in over 80 countries throughout the world. The Company s principal markets are the United States, Europe and Asia.

In the United States, our products are sold by our own sales personnel and through direct marketing and catalog mailings. Outside the United States, we market our products directly in countries in which we have sales offices and through distributors or manufacturers representatives in other countries. Keithley has subsidiary sales and service offices located in Great Britain, Germany, France, the Netherlands, Switzerland, Italy, Japan and Malaysia. We also have sales offices in Belgium, Finland, Sweden, China, Korea, Taiwan, India and Singapore. Sales in areas outside the above named locations are made through independent sales representatives and distributors.

Sources and Availability of Raw Materials

Our products require a wide variety of electronic and mechanical components, most of which are purchased. We have multiple sources for the vast majority of the components and materials we use; however, there are some instances where the components are obtained from a sole-source supplier. If we were unable to purchase components or materials from a sole-source supplier, we could experience a temporary adverse impact on operations; however, we believe alternative sources could be found quickly. Although shortages of purchased materials and components have been experienced from time to time, these items have generally been available as needed.

Patents

Electronic instruments of the nature we design, develop and manufacture generally cannot be patented in their entirety. Although we hold patents with respect to certain of our products, we do not believe our business is dependent to any material extent upon any single patent or group of patents because of the rapid rate of technological change in the industry.

Seasonal Trends and Working Capital Requirements

Our business is not subject to significant seasonal trends. However, many of the industries we serve, including the semiconductor industry, the wireless communications industry and other sectors of the global electronics industry, historically have been cyclical. We do not have any unusual working capital requirements.

Customers

Our customers generally are involved in production test, engineering research and development, electronic service or repair, and educational and governmental research. During the fiscal year ended September 30, 2006, no one customer accounted for more than 10% of our sales. We do not believe that the loss of any one customer would materially affect our sales or net income.

Backlog

Our backlog of unfilled orders amounted to approximately $17,147,000 as of September 30, 2006 and approximately $18,331,000 as of September 30, 2005. We expect that substantially all of the orders included in the 2006 backlog will be delivered during fiscal 2007. A portion of orders included in backlog may be canceled by the customer prior to shipment. The level of backlog at any given time will be affected by the timing of the Company s receipt of orders and the speed with which those orders are filled. Accordingly, the Company s backlog as of September 30, 2006 may not necessarily represent the actual amount of shipments or sales for any future period.

Competition

The Company competes on the basis of quality, performance, service and price, with quality and performance frequently being dominant. There are many firms in the world engaged in the manufacture of electronic measurement instruments, some of which are larger and have greater financial resources than the Company. In general, we compete with a number of companies in specialized areas of the test and measurement industry and one large broad line measurement products supplier, Agilent Technologies, Inc.

Research and Development

Our engineering development activities are directed toward the development of new products that will complement, replace or add to the products currently included in our product line. We do not perform basic research, but on an ongoing basis we utilize new component and software technologies in the development of our products. The highly technical nature of our products and the rapid rate of technological change in the industry require a large and continuing commitment to engineering development efforts. Product development expenses were $23,671,000 in 2006, $17,040,000 in 2005 and $15,017,000 in 2004, or approximately 15%, 12% and 11% of net sales, respectively, for each of the last three fiscal years.

Government Regulations

We believe our current operations and uses of property, plant and equipment conform in all material respects to applicable laws and regulations. Keithley has not experienced, nor do we anticipate, any material claim or material capital expenditure in connection with environmental laws and other regulations.

Employees

As of September 30, 2006, the Company employed approximately 673 persons, 184 of whom were located outside the United States. None of our employees are covered under the terms of a collective bargaining agreement, and we believe that relations with our employees are good.

Foreign Operations and Export Sales

Information related to foreign and domestic operations and export sales is contained in Note L of the Notes to the Consolidated Financial Statements included in Item 8 of this Annual Report.

Keithley has significant revenues from outside the United States which increase the risk to the Company. These risks include increased exposure to the risk of foreign currency fluctuations and the potential economic and political impacts from conducting business in foreign countries. With the exception of changes in the value of foreign currencies, which is not possible to predict, we believe our foreign subsidiaries and other larger international markets are in countries where the economic and political climates generally are stable. The Company also must comply with foreign regulations, which may increase the complexity of conducting its business.

Executive Officers Of The Registrant

Certain information regarding our executive officers is set forth below:

Name	Position	Age
Joseph P. Keithley	Chairman of the Board of Directors, President and Chief Executive Officer	58

Steven A. Chipchase	Vice President Operations	43
Philip R. Etsler	Vice President Human Resources	56
Alan S. Gaffney	Vice President Commercial Marketing and Information Systems	36
Mark A. Hoersten	Vice President Business Management	48
Larry L. Pendergrass	Vice President New Product Development	51
John A. Pesec	Vice President Worldwide Sales and Support	46
Mark J. Plush	Vice President and Chief Financial Officer	57
Linda C. Rae	Executive Vice President and Chief Operating Officer	41

Joseph P. Keithley was elected Chairman of the Board of Directors in February 1991. He was elected Chief Executive Officer in November 1993, and President in May 1994. He has been a Director since 1986, and was elected Vice Chairman of the Board in February 1988. Mr. Keithley joined the Company in 1976 and held various positions in production, customer service, sales and marketing prior to being elected Vice President of Marketing in 1986.

Stephen A. Chipchase was elected Vice President Operations in December 2005. Mr. Chipchase joined Keithley in April 2000 as Materials/ Logistics Manager and held various positions in operations, including Cell Manager from March to July 2003, Acting Director of Operations from July 2003 to February 2004, and Director of Operations from February 2004 to December 2005.

Philip R. Etsler has been Vice President of Human Resources since February 1990. He joined the Company in January 1986 as Personnel Director.

Alan S. Gaffney was elected Vice President Commercial Marketing and Information Systems in May 2003. He joined Keithley in July 1999 as Direct Marketing Manager. He became Director of Worldwide Communications and Marketing Support in May 2000.

Mark A. Hoersten was elected Vice President Business Management in May 2003. He joined Keithley in June 1980 as a Design Engineer and held various positions in product development and marketing until September 1997 when Mr. Hoersten became the Director of Marketing. He was promoted to Telecommunications Test Business Manager in July 1999, and General Manager in April 2001.

Larry L. Pendergrass joined Keithley in May 2003 as Vice President New Product Development. Prior to joining Keithley, Mr. Pendergrass had over 20 years experience in research and development, product development, and manufacturing engineering in various roles including Section Manager, Project Manager and Project Leader with Agilent Technologies and Hewlett-Packard.

John A. Pesec was elected Vice President Worldwide Sales and Support in September 2002. Mr. Pesec joined Keithley in July 1990 and has held various positions with Keithley since then, including Director of Pacific Basin Operations from February 1995 to January 1998, Director Semiconductor Sales from January 1998 to March 1999, Director of Sales from March 1999 to April 2001, and Managing Director Worldwide Sales from April 2001 to September 2002.

Mark J. Plush was elected Vice President and Chief Financial Officer in October 1998. Mr. Plush joined the Company in March 1982 as Controller.

Linda C. Rae was elected Executive Vice President and Chief Operating Officer in December 2005. Ms. Rae joined Keithley in September 1995 as a Product Marketer and has held various marketing positions with Keithley since then, including Component Test Business Manager from July 1999 to June 2000, Business Manager of Optoelectronics from June 2000 to April 2001, General Manager from April 2001 to May 2003, and Senior Vice President and General Manager from May 2003 to December 2005.

ITEM 1A RISK FACTORS

Current and potential shareholders should consider the risk factors described below. Any of these or other factors, many of which are beyond our control, could negatively affect our revenue, results of operations and cash flow.

Cyclicality of the electronics industry and timing of large orders

Many of the industries we serve, including but not limited to the semiconductor industry, the wireless communications industry, and precision electronic components and subassemblies manufacturers, have historically been very cyclical and have experienced periodic downturns. The downturns have had, and may have in the future, a material adverse impact on our customers demand for equipment, including test and measurement equipment. The severity and length of a downturn also may affect overall access to capital, which could adversely affect the Company s customers. In addition, the factors leading to and the severity and length of a downturn are difficult to predict and there can be no assurance that we will appropriately anticipate changes in the underlying end markets we serve or that any increased levels of business activity will continue as a trend into the future. Our orders are cancelable by customers, and consequently, orders outstanding at the end of a reporting period may not result in realized sales in the future. Orders from our top 25 customers of the quarter can generally vary between 30-50 percent of our total orders for any given quarter. This can cause our financial results to fluctuate from quarter to quarter, which may have an adverse impact on our stock price.

Rapid technology changes

Our business relies on the development of new high technology products and services, including products incorporating RF and pulse capabilities, to provide solutions to our customers complex measurement needs. This requires anticipation of customers changing needs and emerging technology trends. We must make long-term investments and commit significant resources before knowing whether our expectations will eventually result in products that achieve market acceptance. We have increased our expenses for new product development; however, our new products may or may not result in significant sources of revenue and earnings in the future. If our new product development investments do not result in future earnings, our operating results could be adversely affected.

Competitive factors

We compete on the basis of product performance, customer service, product availability and price. There are many firms in the world engaged in the manufacture of electronic measurement instruments, and the test and measurement industry is highly competitive. Many of our competitors are larger and have greater financial resources, and/or have established significant reputations within the test and measurement industry and with the customer base we serve. If any of our competitors were to develop products or services that were more cost-effective or technically superior to ours, or if we were unable to differentiate our product offerings from those of our competitors, demand for our products could slow. Additionally, aggressive competition could cause downward pricing pressure, which would reduce our gross margins or cause us to lose market share. We also face competition for personnel with certain highly technical specialties. If we were unable to hire or retain certain key employees, our business could be adversely affected.

Dependence on key suppliers

Our products contain large quantities of electronic components and subassemblies that in some cases are supplied through sole or limited source third-party suppliers. As a result, there can be no assurance that parts and supplies will be available in a timely manner and at reasonable prices. Additionally, our inventory is subject to risks of changes in market demand for particular products. Our inability to obtain critical parts and supplies or any resulting excess and/or obsolete inventory could have an adverse impact on our results of operations.

International operations, political and economic conditions

We currently have subsidiaries or sales offices located in 16 countries outside the United States, and non-U.S. sales accounted for approximately two-thirds of our revenue during fiscal 2006. Our future results could be adversely affected by several factors relating to our international sales operations, including fluctuating foreign currency exchange rates, political unrest, wars and acts of terrorism, changes in other economic or political conditions, trade protection measures, import or export licensing requirements, unexpected changes in regulatory requirements and natural disasters. Any of these factors could have a negative impact on our revenue and operating results.

Changes in manufacturing processes

We have implemented a lean manufacturing environment in our manufacturing facilities, which are located in Solon, Ohio. We may not experience future benefits from lean manufacturing if we are unable to continue to effectively fine-tune our operations, and we could incur additional costs in the future, having a negative impact on gross margin, if new initiatives are needed to further improve manufacturing efficiencies.

Tax planning strategies

We pay taxes in multiple jurisdictions throughout the world. We utilize available tax credits and other tax planning strategies in an effort to minimize our overall tax liability. Our estimated tax rate for fiscal 2007 could change from what is currently anticipated due to changes in tax laws in various countries, changes in our overall tax planning strategy, or changes in the mix of countries where earnings or losses are incurred. At September 30, 2006, we had a valuation allowance against certain deferred tax assets and had not established valuation allowances against other deferred tax assets based on tax strategies planned to mitigate the risk of impairment to these assets. Accordingly, if facts or financial results were to change thereby impacting the likelihood of realizing the deferred tax assets, our tax rate and therefore our earnings could be adversely affected.

Information technology management systems

Our IT systems are critical to our normal business operations, and we rely on them to provide adequate, accurate and timely financial information. Throughout the last three fiscal years, we have implemented new Enterprise Resource Planning, or ERP, and Customer Relationship Management, or CRM, systems, and we intend to further upgrade our information technology systems in the future. We also have outsourced the hosting of these systems to a third-party vendor located in Texas. Our results could be adversely affected if we are unable to implement further system enhancements without significant interruptions in accounting systems, order entry, billing, manufacturing and other customer support functions. If our third-party vendor experiences shuts downs or other service-related issues, it could interrupt our normal business processes including our ability to process orders, ship our products, bill and service our customers, and otherwise run our business, resulting in a material adverse effect on our revenue and operating results.

Fixed cost of sales force

We have continued to build our direct sales force throughout the world with our own employees rather than utilizing third-party sales representatives. This action increases our fixed costs, and our results could be adversely affected during times of depressed sales.

Non-cash compensation expense

We currently grant non-cash compensation in the form of non-qualified stock options, performance share units and restricted share units. The final number of common shares to be issued pursuant to the performance share unit awards will be determined at the end of each three-year performance period. The awards issued in fiscal year 2006 can be adjusted in 50 percent increments and may range from a maximum of twice the initial award, as specified in the agreement, to a minimum of no units depending upon the level of attainment of performance thresholds. We are currently accruing expense for performance share unit awards based upon our estimate that the number of shares to be issued will be equal to the initial award amount. Our future earnings can fluctuate throughout the performance period specified in the agreements depending upon our estimate of the number of awards we expect will be issued upon the completion of the performance period.

Historical stock option grant practices

We delayed the filing of this Form 10-K pending completion of the financial reporting consequences of the previously announced independent investigation into our past stock option grant practices being conducted by a Special Committee of our Board of Directors. Due to these matters, we have experienced substantial additional risks and costs.

As disclosed under Legal Proceedings Stock Option Matters, in August 2006 we established a Special Committee of our Board of Directors to investigate the Company s stock option practices since the beginning of the fiscal year ended September 30, 1995. In addition, we were notified in September 2006 that the staff of the SEC was conducting an informal inquiry into our stock option practices. The Company announced the special committee s findings on December 29, 2006, including that no restatement of the Company s historical financial statements would be required. There can be no assurance, however, that the staff of the SEC will not disagree with this position in the future and require a restatement. In addition, the SEC s informal inquiry continues.

Certain of the Company s Directors and current and former officers have been named as defendants in a consolidated shareholder derivative action filed in the United States District Court for the Northern District of Ohio captioned In Re Keithley Instruments, Inc. Derivative Litigation. The consolidated action seeks to uncover unspecified money damages, discouragement of profits and benefits, equitable injunctive relief and other remedies. The Company is also named as a nominal defendant.

We are not able to predict the future outcome of the SEC inquiry and the derivative action. These matters could result in significant new expenses, diversion of management s attention from our business, commencement of formal similar, administrative or litigation actions against the Company or our current or former employees or Directors, significant fines or penalties, indemnity commitments to current and former officers and Directors and other material harm to our business. The SEC also may disagree with the manner in which we have accounted for and reported (or not reported) the financial impact of past option grants or other potential accounting errors, and there is a risk that its inquiry could lead to circumstances in which we may have to restate our prior financial statements, amend prior SEC filings or otherwise take actions not currently contemplated. Any such circumstance also could lead to future delays in filing of subsequent SEC reports.

Other risk factors

Our business could be affected by worldwide macroeconomic factors. The recent rise in energy prices, as well as rising interest rates, could have a negative impact on the overall economy which could impact our revenue and operating results. Other risk factors include, but are not limited to, changes in our customer and product mix affecting our gross margins, credit risk of customers, potential litigation, claims, regulatory and administrative proceedings arising in the normal course of business, as well as terrorist activities and armed conflicts.

ITEM 1B UNRESOLVED STAFF COMMENTS

None.

ITEM 2 PROPERTIES

The Company s principal administrative, marketing, manufacturing and development activities are conducted at two Company-owned buildings in Solon, Ohio. The Company also leases space in Santa Rosa, California for its RF product development group. The two Company-owned buildings total approximately 200,000 square feet and sit on approximately 33 acres of land. The Company also owns another 50,000 square foot building on 5.5 acres of land adjacent to its executive offices. This facility currently is being leased to others, but is available for expansion should additional space be required. Additionally, we have a number of sales and service offices in the United States and overseas. We believe the facilities owned and leased are well maintained, adequately insured and suitable for their present and intended uses.

ITEM 3 LEGAL PROCEEDINGS

Stock Option Investigations

As previously announced, the Company s management initiated an internal review of its stock option practices in light of concerns raised at other companies. Following that internal review, in August 2006 the Company s Board of Directors formed a Special Committee of independent directors to investigate the Company s stock option practices since the beginning of the fiscal year ended September 30, 1995. The Committee retained Jones Day as its independent counsel to assist it in the investigation (the Independent Counsel).

Following appointment of the Special Committee, the Company voluntarily notified the staff of the SEC of the Special Committee investigation. In September 2006, the Company received notice that the SEC was conducting an inquiry into the Company s option grant practices. The SEC s investigation is ongoing and the Company continues to cooperate with the SEC staff.

The Special Committee s findings, which have been adopted by the Board of Directors, are as follows:

- There was no evidence of backdating annual stock option grants prior to the date of approval by the Board of Directors.
- There was a multi-day delay by management in setting the exercise price for annual stock option grants in 2000, 2001 and 2002. The delay resulted in the options having a lower exercise price than the price on the date of Board approval. In each of these three years, the price selected by management was the lowest price for the Company s common shares for the period between Board approval and the administrative recording of the grants.

Although the Special Committee determined that the terms of the Company s stock incentive plans required the options to be priced on the date the Board approved them, there was no finding of intentional misconduct on the part of senior management or any other Keithley officer, Director or employee responsible for the administration of the Company s stock option grants. Notwithstanding the fact that management exceeded its authority under the Company s plans, the Company will honor the options in accordance with the terms as they were set by management.

Based on evidence gathered and analyzed by the Independent Counsel, the Special Committee found the dates selected by management for the annual grants in 2000-2002 are the appropriate measurement dates for accounting purposes. Accordingly, it is unnecessary for the Company to record any compensation expense with respect to the annual option grants in 2000-2002, and therefore there is no need for the Company to restate its financial statements as a result of these grants.

The Special Committee concluded that there were no material misstatements in the Company s public filings regarding the number of annual options granted during the years reviewed; there is no evidence that the Company timed the grant date or pricing of annual stock option grants to take advantage of material non-public information and there was no wrongdoing or lack of oversight by the Company s independent directors or the Human Resources and Compensation Committee of the Board of Directors (the Compensation Committee).

The Special Committee also reviewed the Company s practices regarding stock option grants, other than its annual grants, which are generally grants of smaller numbers of options to new hires and to existing employees for promotions. The Special Committee concluded that management exceeded certain aspects of the authority granted to management by the Company s stock option plans and the Compensation Committee, but that these grants involved small numbers of shares and were largely the result of ministerial errors by management.

None of the options that were part of the 2000-2002 annual grants have been exercised by any executive officer of the Company and none of the options are currently in the money.

As a result of the investigation, the Company s Compensation Committee has adopted additional procedures for the granting of equity awards that govern how stock options and other equity awards will be granted and documented. Among other things, the policy makes it clear that, for annual grants, options must have an exercise price equal to the closing price of the Common Shares on the date the Committee approves them unless the Committee specifically establishes another price or method for determining the price at the time it approves them. The policy also clarifies the extent of any authority delegated to management to make grants other than annual grants. In addition, the Board of Directors has initiated a search for a general counsel and chief compliance officer who will, among other things, have involvement in the Company s equity award process.

As a result of the costs and management time incurred by the Company in connection with the investigation, the Company has determined that Joseph P. Keithley, the Company s Chairman of the Board, President and Chief Executive Officer, and Mark J. Plush, the Company s Chief Financial Officer, will not receive a bonus for fiscal 2006, a salary increase for calendar year 2007, or any equity grants prior to the annual grants expected to be made in November 2007, and that Philip R. Etsler, the Company s Vice President of Human Resources, will not receive a bonus for fiscal 2006, a salary increase for calendar year 2007 or any options prior to the time of the annual grants expected to be made in November 2007, although he is expected to receive performance shares in connection with the 2006 annual grants expected to be made to employees shortly following the filing of this Form 10-K.

Derivative Litigation

On August 9, 2006 and August 15, 2006, the Company was named as a nominal defendant in two separate shareholder derivative suits, Nathan Diamond v. Joseph P. Keithley, et al., Cuyahoga County, Ohio, Court of Common Pleas (Diamond) and Michael C. Miller v. Joseph P. Keithley, et al, Cuyahoga County, Ohio, Court of Common Pleas (Miller). Both suits were removed to the United States District Court for the Northern District of Ohio on September 8, 2006. Miller and Diamond were consolidated before the Hon. Judge Christopher Boyko. On November 13, 2006, the plaintiffs filed a consolidated Complaint (the Consolidated Complaint).

On October 23, 2006 and October 24, 2006, the Company was named as a nominal defendant in two additional shareholder derivative lawsuits, Edward P. Hardy v. Joseph P. Keithley, et al., in the United States District Court for the Northern District of Ohio and Mike Marks v. Joseph P. Keithley, in the United States District Court for the Northern District of Ohio.

At a Case Management Conference on December 4, 2006, Judge Christopher A. Boyko of the United States District Court for the Northern District of Ohio orally ordered that the four cases be consolidated into a single action in that court. The Company expects the Judge s written order reflecting this consolidation to be entered shortly. The Consolidated Complaint alleges that various Company officers and/or directors manipulated the dates on which stock-options were granted by the Company so as to maximize the value of the stock options or knew or should have known of such manipulation by others. The suits allege numerous claims, including violations of Sections 10(b), 10b(5) and 20(a) of the Securities Exchange Act of 1934, breaches of fiduciary duties, aiding and abetting, corporate waste, unjust enrichment and rescission.

Other

In the normal course of business, the Company is subject to various other legal claims, actions, complaints and other matters. While the results of such matters cannot be predicted with certainty, management believes that the final outcome of pending matters known to management will not have a material adverse impact on the financial position or results of operations of the Company.

ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matter was submitted to a vote of security holders during the fourth quarter of the fiscal year covered by this report.

PART II

ITEM 5 MARKET FOR THE REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The Company s Common Shares trade on the New York Stock Exchange under the symbol KEI. The high and low prices shown below are sales prices of the Company s Common Shares as reported on the NYSE. There is no established public trading market for the Class B Common Shares; however, they are readily convertible on a one-for-one basis into Common Shares.

Fiscal 2006	**High**	**Low**	**Cash Dividends Per Common Share**	**Cash Dividends Per Class B Common Share**
First Quarter	$16.30	$13.81	$ .0375	$ .0300
Second Quarter	15.95	13.71	.0375	.0300
Third Quarter	16.10	11.36	.0375	.0300
Fourth Quarter	13.43	10.77	.0375	.0300
Fiscal 2005				
First Quarter	$19.99	$15.96	$ .0375	$ .0300
Second Quarter	19.70	15.58	.0375	.0300
Third Quarter	16.33	12.90	.0375	.0300
Fourth Quarter	16.55	13.05	.0375	.0300

The approximate number of shareholders of record of Common Shares and Class B Common Shares, including those shareholders participating in the Dividend Reinvestment Plan, as of December 12, 2006 was 2,266 and 4, respectively.

Equity Compensation Plan Information as of September 30, 2006

Plan category	**Number of securities to be issued upon exercise of outstanding options (a)**	**Weighted-average exercise price of outstanding options (b)**	**Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a) (c)**
Equity compensation plans approved by security holders	3,297,981	$ 19.65	1,528,389(1)
Equity compensation plans not approved by security holders			
Total	**3,297,981**	**$ 19.65**	**1,528,389(1)**

(1) Includes 81,119 shares available for issuance under the 1993 Employee Stock Purchase and Dividend Reinvestment Plan and 490,590 shares available for issuance under the 2005 Employee Stock Purchase and Dividend Reinvestment Plan.

Issuer Purchases of Equity Securities

The following table sets forth, for the months indicated, our purchases of Common Shares in the fourth quarter of fiscal year 2006:

	Total number of shares purchased	**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**
July 1 31, 2006	150,000	$ 12.40	150,000	1,635,000
August 1 11, 2006	40,500	$ 11.27	40,500	1,594,500
Total	190,500	$ 12.16	190,500	1,594,500

On December 10, 2003, the Company announced that its Board of Directors had approved an open market stock repurchase program (the 2003 program). Under the terms of the 2003 program, the Company may purchase up to 2,000,000 Common Shares, which represented approximately 13 percent of the outstanding shares at the time the program was announced, over a three-year period ending December 31, 2006. The purpose of the 2003 program is to offset the dilutive effect of stock compensation and stock purchase plans, and to provide value to shareholders. Common Shares held in treasury may be reissued in settlement of stock purchases under the stock option and stock purchase plans.

ITEM 6 SELECTED FINANCIAL DATA.

The following data has been derived from financial statements audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm. Consolidated Balance Sheets as of September 30, 2006 and 2005 and the related Consolidated Statements of Operations and of Cash Flows for each of the three years in the period ended September 30, 2006 and notes thereto appear elsewhere in this Annual Report.

	For the years ended September 30,				
(In thousands of dollars except for per share data)	**2006**	**2005**	**2004**	**2003**	**2002**
Operating Results:					
Net sales	$ 155,212	141,552	140,248	106,718	96,922
Gross margin percentage	61.3%	60.7%	61.1%	55.3%	56.2%
Income (loss) before income taxes	$ 9,913	14,087	15,541	(4,361)	(5,046)
Net income (loss)	$ 8,361	10,128	11,381	(4,192)	(3,080)
Basic earnings (loss) per share	$ 0.51	0.62	0.71	(0.27)	(0.20)
Diluted earnings (loss) per share	$ 0.50	0.61	0.69	(0.27)	(0.20)
Common Stock Information:					
Cash dividends per Common Share	$ 0.15	0.15	0.15	0.15	0.15
Cash dividends per Class B Common Share	$ 0.12	0.12	0.12	0.12	0.12
Weighted average number of shares outstanding-diluted	16,567	16,591	16,544	15,487	15,687
At fiscal year-end:					
Dividend payout ratio	30.0%	24.6%	21.7%	n/m	n/m
Shareholders equity per share	$ 7.03	6.81	6.26	5.33	5.81
Closing market price	$ 12.75	14.60	17.45	14.15	12.15
Balance Sheet Data:					
Total assets	$ 148,892	142,364	136,666	114,186	120,371
Current ratio	4.2	4.2	3.3	3.4	3.9
Short-term debt	$ 872		440	409	539
Long-term obligations	$ 9,792	8,240	7,348	9,631	7,170
Shareholders equity	$ 116,503	111,976	101,577	84,763	92,448
Total debt-to-capital	0.7%		0.4%	0.5%	0.6%
Other Data:					
Return on average shareholders equity	7.3%	9.5%	12.2%	-4.7%	-3.3%
Return on average total assets	5.7%	7.3%	9.1%	-3.6%	-2.5%
Return on net sales	5.4%	7.2%	8.1%	-3.9%	-3.2%
Number of employees	673	651	632	608	612
Sales per employee	$ 234.5	220.7	226.2	174.9	154.8
Cash flow:					
Net cash provided by (used in) operating activities	$ 5,985	10,543	15,045	(6,530)	7,815
Ten-year compound annual growth rate:					
Net sales	2.7%	2.6%	4.6%	1.6%	0.2%
Net income	n/m	7.5%	28.8%	n/m	n/m

n/m These ratios are not meaningful due to the reported net losses in 1996, 2002 and 2003.

ITEM 7 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

In Thousands of Dollars except for per share information.

Introduction and Overview

This Management s Discussion and Analysis of Financial Condition and Results of Operations is intended to provide investors with an understanding of the operating performance and financial condition of Keithley Instruments, Inc. A discussion of our business, including our strategy for growth, products and competition, is included in Part I of this Form 10-K.

Business Overview

Our business is to design, develop, manufacture and market complex electronic instruments and systems geared to the specialized needs of electronics manufacturers for high-performance production testing, process monitoring, product development and research. Our primary products are integrated systems used to source, measure, connect, control or communicate electrical direct current (DC), radio frequency (RF) or optical signals. Our customers are engineers, technicians and scientists in manufacturing, product development and research functions. During fiscal 2006, approximately 35 percent of our orders were received from the semiconductor industry. Approximately 15 percent came from research and education customers. Approximately 10 percent came from the wireless communications customer group. Approximately 30 percent came from the precision electronic components and subassembly manufacturers customer group, which includes customers in automotive, computers and peripherals, medical equipment, aerospace and defense, and manufacturers of components, including optoelectronic components. The remainder of orders came from customers in a variety of other industries. Although our products vary in capability, sophistication, use, size and price, they generally test, measure and analyze electrical, RF, optical or physical properties. As such, we consider our business to be in a single industry segment.

Many of the industries we serve, including but not limited to the semiconductor industry, the wireless communications industry, the optoelectronics industry, and precision electronic components and subassembly manufacturers, have historically been very cyclical and have experienced periodic downturns. During fiscal 2004, 2005 and 2006, we noted improving conditions in the health of our customers following a downturn in the electronics industry during 2001 through 2003. We continue to believe that our ability to achieve a higher level of orders in the future will be driven by our customers spending patterns as they invest in new capacity or upgrade their lines for their new product offerings, as well as our ability to gain market share.

Our focus during the past several years has been on building long-term relationships and strong collaborative partnerships with our global customers to serve their measurement needs. Toward that end, we have been moving toward employing our own sales personnel to sell our products, as opposed to selling our products through sales representatives to whom we pay a commission. The change in our sales channel allows us to build a sales network of focused, highly trained sales engineers who specialize in measurement expertise and problem-solving for customers and enhances our ability to sell our products to customers with worldwide operations. We believe our ability to serve our customers has been aided immeasurably by deploying our own employees throughout the Americas, Europe and, most recently, Asia. We expect that selling through our own sales force will be favorable to earnings during times of strong sales and unfavorable during times of depressed sales as a greater portion of our selling costs are now fixed.

Over the past few years we have incurred costs for the transition to new ERP and CRM software systems. Implementations that have occurred to date have caused minimal disruptions to our business; however, we will continue our ERP and CRM technology upgrades in various loca