

KEITHLEY INSTRUMENTS INC

Form 10-Q

August 09, 2007

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended June 30, 2007**

OR

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
Commission File Number 1-9965
KEITHLEY INSTRUMENTS, INC.
(Exact name of registrant as specified in its charter)**

Ohio

(State or other jurisdiction of incorporation or
organization)

34-0794417

(I.R.S. Employer Identification No.)

28775 Aurora Road, Solon, Ohio 44139

(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (440) 248-0400

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES NO

Indicate by check 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 Accelerated filer Non-accelerated filer

Indicate by check whether the registrant is a shell Company (as defined in Rule 12b-2 of the Exchange Act).

YES NO

As of August 6, 2007 there were outstanding 14,120,538 Common Shares without par value and 2,150,502 Class B Common Shares, without par value.

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Forward-Looking Statements

Statements and information included in this Quarterly Report on Form 10-Q 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 Report include statements regarding Keithley s expectations, intentions, beliefs, and strategies regarding the future, including recent trends, cyclicity, 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 II of this Form 10-Q.

Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. Financial Statements.**

KEITHLEY INSTRUMENTS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In Thousands of Dollars)
(Unaudited)

| | June 30, 2007 | 2006 | September 30, 2006 |
|--|------------------|------------|--------------------------|
| Assets | | | |
| Current assets: | | | |
| Cash and cash equivalents | \$ 14,262 | \$ 8,502 | \$ 10,501 |
| Short-term investments | 33,049 | 45,068 | 36,203 |
| Refundable income taxes | 393 | 132 | 583 |
| Accounts receivable and other, net | 19,607 | 21,828 | 26,836 |
| Inventories: | | | |
| Raw materials | 8,539 | 10,051 | 9,375 |
| Work in process | 1,184 | 1,766 | 1,208 |
| Finished products | 4,168 | 3,676 | 4,064 |
| Total inventories | 13,891 | 15,493 | 14,647 |
| Deferred income taxes | 3,920 | 4,199 | 4,206 |
| Other current assets | 1,891 | 1,781 | 1,664 |
| Total current assets | 87,013 | 97,003 | 94,640 |
| Property, plant and equipment, at cost | 51,328 | 50,371 | 49,968 |
| Less-Accumulated depreciation | 37,031 | 35,558 | 35,543 |
| Net property, plant and equipment | 14,297 | 14,813 | 14,425 |
| Deferred income taxes | 21,378 | 16,843 | 17,679 |
| Other assets | 24,057 | 17,190 | 22,148 |
| Total assets | \$ 146,745 | \$ 145,849 | \$ 148,892 |
| Liabilities and Shareholders' Equity | | | |
| Current liabilities: | | | |
| Short-term debt | \$ 21 | \$ 1,004 | \$ 872 |
| Accounts payable | 7,595 | 8,219 | 8,033 |
| Accrued payroll and related expenses | 4,510 | 5,483 | 6,089 |
| Other accrued expenses | 3,780 | 4,350 | 4,870 |
| Income taxes payable | 1,729 | 2,171 | 2,733 |
| Total current liabilities | 17,635 | 21,227 | 22,597 |
| Long-term deferred compensation | 3,941 | 3,406 | 3,549 |
| Other long-term liabilities | 6,884 | 5,566 | 6,243 |

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Shareholders' equity:

Common Shares, stated value \$.0125:

Authorized - 80,000,000; issued and outstanding - 14,518,231 at June 30, 2007, 14,380,656 at June 30, 2006 and 14,410,245 at September 30, 2006

181 179 180

Class B Common Shares, stated value \$.0125:

Authorized - 9,000,000; issued and outstanding - 2,150,502 at June 30, 2007, June 30, 2006 and September 30, 2006

27 27 27

Capital in excess of stated value

36,423 32,592 33,703

Retained earnings

87,160 86,315 88,393

Accumulated other comprehensive income

1,073 581 615

Common shares held in treasury, at cost

(6,579) (4,044) (6,415)

Total shareholders' equity

118,285 115,650 116,503

Total liabilities and shareholders' equity

\$ 146,745 \$ 145,849 \$ 148,892

The accompanying notes are an integral part of these financial statements.

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KEITHLEY INSTRUMENTS, INC.
 CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
 (In Thousands of Dollars Except for Per Share Data)
 (Unaudited)

| | For the Three Months | | For the Nine Months | |
|--|----------------------|-----------|---------------------|------------|
| | Ended June 30, | | Ended June 30, | |
| | 2007 | 2006 | 2007 | 2006 |
| Net sales | \$ 33,446 | \$ 38,427 | \$ 107,402 | \$ 113,896 |
| Cost of goods sold | 14,059 | 15,000 | 43,461 | 44,051 |
| Gross profit | 19,387 | 23,427 | 63,941 | 69,845 |
| Selling, general and administrative expenses | 15,288 | 15,848 | 48,255 | 46,557 |
| Product development expenses | 7,116 | 6,357 | 19,363 | 17,343 |
| Operating (loss) income | (3,017) | 1,222 | (3,677) | 5,945 |
| Investment income | 582 | 510 | 1,715 | 1,422 |
| Interest expense | (11) | (2) | (38) | (8) |
| (Loss) income before income taxes | (2,446) | 1,730 | (2,000) | 7,359 |
| Income tax (benefit) provision | (1,987) | 61 | (2,543) | 1,666 |
| Net (loss) income | \$ (459) | \$ 1,669 | \$ 543 | \$ 5,693 |
| Basic (loss) earnings per share | \$ (0.03) | \$ 0.10 | \$ 0.03 | \$ 0.35 |
| Diluted (loss) earnings per share | \$ (0.03) | \$ 0.10 | \$ 0.03 | \$ 0.34 |
| Cash dividends per Common Share | \$.0375 | \$.0375 | \$.1125 | \$.1125 |
| Cash dividends per Class B Common Share | \$.030 | \$.030 | \$.090 | \$.090 |

The accompanying notes are an integral part of these financial statements.

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KEITHLEY INSTRUMENTS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousands of Dollars)
(Unaudited)

| | For the Nine Months Ended June 30, | |
|---|---------------------------------------|----------|
| | 2007 | 2006 |
| Cash flows from operating activities: | | |
| Net income | \$ 543 | \$ 5,693 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 3,137 | 2,882 |
| Stock-based compensation | 1,689 | 1,770 |
| Deferred income taxes | (3,577) | 1,278 |
| Other items not effecting outlay of cash | 542 | 303 |
| Changes in working capital | 3,980 | (6,576) |
| Other operating activities | (941) | (218) |
| Net cash provided by operating activities | 5,373 | 5,132 |
| Cash flows from investing activities: | | |
| Payments for property, plant and equipment | (3,054) | (3,943) |
| Purchase of short-term investments | (23,920) | (32,683) |
| Sale of short-term investments | 27,152 | 28,407 |
| Net cash generated in (used in) investing activities | 178 | (8,219) |
| Cash flows from financing activities: | | |
| Net (payments) borrowing under short term debt agreements | (857) | 990 |
| Cash dividends | (1,776) | (1,803) |
| Purchase of treasury shares | | (2,711) |
| Proceeds from stock purchase and option plans | 338 | 284 |
| Excess tax benefits from stock-based compensation arrangements | 298 | 217 |
| Net cash used in financing activities | (1,997) | (3,023) |
| Effect of exchange rate changes on cash | 207 | 215 |
| Increase (decrease) in cash and cash equivalents | 3,761 | (5,895) |
| Cash and cash equivalents at beginning of period | 10,501 | 14,397 |
| Cash and cash equivalents at end of period | \$ 14,262 | \$ 8,502 |

The accompanying notes are an integral part of these financial statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands of dollars, except for per-share data)

A. Nature of Operations

The business of Keithley Instruments, Inc. is to design, develop, manufacture and market complex electronic instruments and systems to serve 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. 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.

B. Summary of Significant Accounting Policies

Basis of Presentation

The condensed consolidated financial statements at June 30, 2007 and 2006, and for the three month and nine month periods then ended have not been audited by an independent registered public accounting firm, but in the opinion of our management, all adjustments necessary to fairly present the consolidated balance sheets, consolidated statements of operations and consolidated statements of cash flows for those periods have been included. All adjustments included are of a normal recurring nature. The year-end condensed balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

The Company's condensed consolidated financial statements for the three and nine month periods ended June 30, 2007 and 2006 included in this Form 10-Q report have been prepared in accordance with the accounting policies described in the Notes to Consolidated Financial Statements for the year ended September 30, 2006, which were included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2006 filed on December 29, 2006 (the 2006 Form 10-K). Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. These financial statements should be read in conjunction with the financial statements and the notes thereto included in the 2006 Form 10-K.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the reported financial statements and the reported amounts of revenues and expenses during the reporting periods. Examples include the allowance for doubtful accounts, estimates of contingent liabilities, inventory valuation, pension plan assumptions, estimates and assumptions relating to stock-based compensation costs, and the assessment of the valuation of deferred income taxes and income tax reserves. Actual results could differ materially from those estimates.

Reclassifications

Certain reclassifications have been made to prior year financial statements and the notes thereto to conform to the current year presentation.

C. Recent Accounting Pronouncements

In February 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments, which amends SFAS 133 Accounting for Derivative Instruments and Hedging Activities and SFAS 140 Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. SFAS No. 155 simplifies the accounting for certain derivatives embedded in other financial instruments by allowing them to be accounted for as a whole if the holder elects to account for the whole instrument on a fair value basis. SFAS No. 155 also clarifies and amends certain other provisions of SFAS No. 133 and SFAS No. 140. SFAS No. 155 is effective for all financial instruments acquired, issued or

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subject to a remeasurement event occurring in fiscal years beginning after September 15, 2006. The adoption of SFAS No. 155 did not have a material impact on our consolidated financial statements.

In July 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement 109. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. It also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006, although early adoption is encouraged. The Company is currently evaluating the impact of this Interpretation on its financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the Board having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently evaluating the impact of this Statement on its financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin (SAB) No. 108 regarding the process of quantifying financial statement misstatements. SAB No. 108 states that registrants should use both a balance sheet approach and an income statement approach when quantifying and evaluating the materiality of a misstatement. The interpretations in SAB No. 108 contain guidance on correcting errors under the dual approach, and provide transition guidance for correcting errors. This interpretation does not change the requirements within SFAS No. 154, Accounting Changes and Error Corrections a replacement of APB No. 20 and FASB Statement No. 3, for the correction of an error on financial statements. SAB No. 108 is effective for annual financial statements covering the first fiscal year ending after November 15, 2006. The adoption of SAB No. 108 is not expected to have a material impact on our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R). SFAS No. 158 represents the completion of the first phase in the FASB s postretirement benefits accounting project and requires an employer that is a business entity and sponsors one or more single employer benefit plans to (1) recognize the over-funded or under-funded status of the benefit plan in its statement of financial position, (2) recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs of credits that arise during the period but are not recognized as components of net periodic benefit cost, (3) measure defined benefit plan assets and obligations as of the end of the employer s fiscal year, and (4) disclose in the notes to financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation. The provisions of SFAS No. 158 are effective as of September 30, 2007, except for the measurement date provisions, which are effective for fiscal years ending after December 15, 2008. The impact of adopting SFAS No. 158 cannot be determined until the actuarial valuations are completed and the plan asset values are determined for the current year ending September 30, 2007. However, based upon the funded status of the Company s pension plans at September 30, 2006, the adoption of SFAS No. 158 would have reduced total stockholders equity by approximately \$6,109 on a pretax basis at September 30, 2006. By the time we adopt SFAS No. 158 as of September 30, 2007, plan performance and actuarial assumptions could have a significant impact on the actual amounts recorded.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FAS 115. SFAS No. 159 allows companies to choose, at specified election dates, to measure eligible financial assets and liabilities at fair value that are not otherwise required to be measured at fair value. Unrealized gains and losses shall be reported on items for which the fair value option has been elected in earnings at each subsequent reporting date. SFAS No. 159 also establishes presentation and disclosure requirements. It is effective for fiscal years beginning after November 15, 2007 and will be applied prospectively. The adoption of SFAS No. 159 is not expected to have a material impact on our consolidated financial statements.

Table of Contents**D. Earnings Per Share**

Both Common Shares and Class B Common Shares are included in calculating earnings per share. The weighted average number of shares outstanding used in the calculation is set forth below:

| | For the Three Months Ended June 30, | | For the Nine Months Ended June 30, | |
|--|--|----------------|---------------------------------------|----------------|
| | 2007 | 2006 | 2007 | 2006 |
| Net (loss) income | \$ (459) | \$ 1,669 | \$ 543 | \$ 5,693 |
| Weighted averages shares outstanding | 16,252,296 | 16,454,185 | 16,204,214 | 16,464,532 |
| Dilutive effect of stock awards | | 160,120 | 201,099 | 181,803 |
| Assumed purchase of stock under stock purchase plan | | 1,662 | 1,153 | 1,859 |
| Weighted average shares used for dilutive earnings per share | 16,252,296 | 16,615,967 | 16,406,466 | 16,648,194 |
| Basic earnings per share | \$ (0.03) | \$ 0.10 | \$ 0.03 | \$ 0.35 |
| Diluted earnings per share | \$ (0.03) | \$ 0.10 | \$ 0.03 | \$ 0.34 |

Due to the net loss for the three months ended June 30, 2007, 196,822 shares were excluded from the dilutive calculation from stock awards and the stock purchase plan.

E. Stock-based Compensation

The Company currently has one equity-based compensation plan from which stock-based compensation awards can be granted to employees and Directors. In addition, we have two plans that were terminated or have expired, but which have options currently outstanding. The Company also has an employee stock purchase plan (ESPP) that provides employees with the opportunity to purchase Common Shares at 95 percent of the fair market value at the end of the one-year subscription period. The provisions of the ESPP are such that measurement of compensation expense is not required by SFAS No. 123R Share-Based Payments. Additionally, no shares were issued pursuant to the ESPP during the nine months of fiscal year 2007 or 2006.

Stock option activity

During the first nine months of fiscal 2007, the Company granted 106,025 non-qualified stock options with a weighted average exercise price of \$13.91 to officers and other key employees. The exercise price of the options is equal to the fair market value on their respective grant date. The only options issued during fiscal 2006 were issued during the first quarter. During the first quarter of fiscal 2006, the Company granted 165,651 non-qualified stock options to officers and other key employees. The options have an exercise price equal to the \$15.05 market value of the shares on the grant date. The awards granted in both periods have a term of ten years, vest fifty percent after two years, and an additional twenty five percent each after years three and four.

The fair value of the options granted during the first nine months of fiscal 2007 and 2006 was \$5.41 and \$5.93 per share, respectively. The fair values were determined using the Black-Scholes option-pricing model. The following assumptions were applied for options granted during these periods:

| | Nine Months Fiscal 2007 | Nine Months Fiscal 2006 |
|-------------------------|-------------------------------|-------------------------------|
| Expected life (years) | 4.75 | 4.5 |
| Risk-free interest rate | 4.79% | 4.27% |
| Volatility | 42% | 45% |
| Dividend yield | 1.07% | 1.01% |

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The risk-free interest rate and dividend yield were obtained from published sources based upon factual data. In order to determine the expected life, we considered the exercise and cancellation behavior of past grants to model expected future patterns. We also considered the life of options currently outstanding. To determine the volatility assumption, we primarily relied upon historical volatility of Keithley's stock price. Little reliance was placed on implied volatility as there is not a large enough market for exchange-traded options.

Performance award units

During the first nine months of fiscal 2007, the Company granted 142,800 performance award units to officers and other key employees with a weighted average fair market value per unit on the grant dates of \$13.95. During the first nine months of fiscal year 2006, the Company granted 164,025 performance award units with a weighted average fair value of \$15.05 per share. The performance award unit agreements granted during both fiscal years provide for the award of performance units with each unit representing the right to receive one of the Company's Common Shares to be issued after the applicable award period. The award period for performance award units issued in fiscal 2007 will end on September 30, 2009, while the award period for awards issued during fiscal 2006 will end on September 30, 2008. The final number of units earned pursuant to an award may range from a minimum of no units to a maximum of twice the initial award. The awards issued during fiscal year 2007 may be adjusted in 25 percent increments, while the awards issued during fiscal year 2006 may be adjusted in 50 percent increments. The number of units earned will be based on the Company's revenue growth relative to defined peer groups, and the Company's return on assets or return on invested capital during the applicable performance period as defined in the agreements. Each reporting period, the compensation cost of the performance award units is subject to adjustment based upon our estimate of the number of awards we expect will be issued upon the completion of the performance period. We are currently expensing all performance awards at target levels.

Restricted award units

During the first nine months of fiscal year 2007, the Company granted 25,050 restricted award units to key employees other than officers. The awards have a weighted average fair market value per unit of \$13.61 based upon the fair value of the Company's stock on the award dates. During the first nine months of fiscal year 2006, the Company granted 16,175 restricted award units with a weighted average fair market value per unit on the grant dates of \$15.05. The restricted unit award agreements provide for the award of restricted units with each unit representing one share of the Company's Common Shares. Generally, the awards vest on the fourth anniversary of the award date, subject to certain conditions specified in the agreement. The vesting date may be earlier than four years in certain cases to accommodate individuals' planned retirement dates.

Directors' equity plans

Non-employee Directors receive an annual Common Share grant equal to \$58. The Common Shares are to be issued out of the Keithley Instruments, Inc. 2002 Stock Incentive Plan.

The Board of Directors also may issue restricted stock grants worth \$75 to a new non-employee Director at the time of his or her election. These restricted stock grants vest over a 3-year period. There were no such grants issued during the first nine months of fiscal year 2007.

Compensation costs recorded

The table below summarizes stock-based compensation expense recorded under SFAS 123R for the three month and nine month periods ended June 30, 2007 and 2006.

| | For the Three Months Ended June 30, | | For the Nine Months Ended June 30, | |
|---|--|-------|---------------------------------------|-------|
| | 2007 | 2006 | 2007 | 2006 |
| Cost of goods sold | \$ 45 | \$ 29 | \$ 102 | \$ 84 |
| Selling, general and administrative expenses | 504 | 503 | 1,346 | 1,476 |
| Product development expenses | 99 | 71 | 241 | 211 |
| Stock-based compensation included in operating expenses | 648 | 603 | 1,689 | 1,771 |
| Estimated tax impact of stock-based compensation | 213 | 205 | 554 | 600 |

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| | | | | |
|--|--------|--------|----------|----------|
| Stock-based compensation expense, net of tax | \$ 435 | \$ 398 | \$ 1,135 | \$ 1,171 |
|--|--------|--------|----------|----------|

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The excess tax benefits recognized during the first nine months of fiscal year 2007 and 2006 were approximately \$298 and \$205, respectively.

As of June 30, 2007, there was \$4,058 of total pretax unrecognized compensation cost related to nonvested awards.

That cost is expected to be recognized over a weighted-average period of 2.2 years.

F. Repurchase of Common Shares

On February 12, 2007, the Company announced its Board of Directors had approved an open market stock repurchase program (the 2007 Program). Under the terms of the 2007 Program, the Company may purchase up to 2,000,000 Common Shares, which represents approximately 12 percent of its total outstanding Common Shares, through February 28, 2009. The 2007 Program replaces the prior repurchase program (the 2003 Program), which expired on December 31, 2006. The purpose of the 2007 and 2003 Programs was to offset the dilutive effect of stock option and stock purchase plans, and to provide value to shareholders. Common Shares held in treasury may be reissued in settlement of purchases under these stock plans.

There were no purchases under 2007 Program during the first nine months of fiscal year 2007. At June 30, 2007, there were 405,500 Common Shares remaining in treasury at an average cost, including commissions, of \$12.40 pursuant to the repurchase programs.

The following table summarizes the Company's stock repurchase activity during the first nine months of fiscal 2006:

| | Three and Nine Months Ended June 30, 2006 |
|---|---|
| Total number of shares purchased | 215,000 |
| Average price paid per share (including commissions) | \$ 12.61 |
| Identity of broker-dealer used to effect the purchases | National Financial Securities LLC |
| Number of shares purchased as part of a publicly announced repurchase program | 215,000 |
| Maximum number of shares that remain to be purchased under the program | 1,785,000 |

Also, included in the Common shares held in treasury, at cost caption of the consolidated balance sheets are shares repurchased to settle non-employee Directors' fees deferred pursuant to the Keithley Instruments, Inc. 1996 Outside Directors Deferred Stock Plan. Shares held in treasury pursuant to this plan totaled 160,568 and 140,742 at June 30, 2007 and 2006, respectively.

G. Financing Arrangements

On March 29, 2007, the Company extended the term of its credit agreement, as amended, to March 31, 2010 from March 31, 2009. The agreement is a \$10,000 debt facility (\$0 outstanding at June 30, 2007) that provides unsecured, multi-currency revolving credit at various interest rates based on Prime or LIBOR. The Company is required to pay a facility fee of 0.125% per annum on the total amount of the commitment. The agreement may be extended annually. Additionally, the Company has a number of other credit facilities in various currencies and for standby letters of credit aggregating \$5,000 (\$21 of short-term debt and \$703 for standby letters of credit outstanding at June 30, 2007). At June 30, 2007, the Company had total unused lines of credit with domestic and foreign banks aggregating \$14,276 of which \$10,000 was long-term and \$4,276 was a combination of long-term and short-term depending upon the nature of the indebtedness.

Under certain provisions of the debt agreements, the Company is required to comply with various financial ratios and covenants. The Company was in compliance with all such debt covenants as of June 30, 2007.

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In accordance with the provisions of SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities (as amended), all of the Company's derivative instruments are recognized on the balance sheet at their fair value. To hedge sales, the Company currently utilizes foreign exchange forward contracts or option contracts to sell foreign currencies to fix the exchange rates related to near-term sales and effectively fix the Company's margins. Underlying hedged transactions are recorded at hedged rates, therefore realized and unrealized gains and losses are recorded when the hedged transactions occur.

On the date the derivative contract is entered into, the Company designates its derivative as either a hedge of the fair value of a recognized asset or liability (fair value hedge), as a hedge of the variability of cash flows to be received (cash flow hedge), or as a foreign-currency cash flow hedge (foreign currency hedge). Changes in the fair value of a derivative that is highly effective as, and that is designated and qualifies as, a fair value hedge, along with the gain or loss on the hedged asset or liability that is attributable to the hedged risk are recorded in current period earnings.

Changes in the fair value of a derivative that is highly effective as, and that is designated and qualifies as a cash flow hedge, are recorded in other comprehensive income until earnings are affected by the transaction in the underlying asset. Changes in the fair value of derivatives that are highly effective and that qualify as foreign currency hedges are recorded in either current period income or other comprehensive income, depending on whether the hedge transaction is a fair value hedge or a cash flow hedge. At June 30, 2007, the foreign exchange forward contracts were designated as foreign currency cash flow hedges.

At June 30, 2007, the Company had obligations under foreign exchange forward contracts to sell 2,300,000 Euros, 655,000 British pounds and 280,000,000 Yen at various dates through October 2007. In accordance with the provisions of SFAS No. 133, the derivative instruments are recorded on the Company's Consolidated Balance Sheets. The fair market value of the foreign exchange forward contracts represented an asset/(liability) to the Company of \$30 and \$(17), at June 30, 2007 and 2006, respectively.

The Company documents all relationships between hedging instruments and hedged items, as well as its risk-management objective and strategy for undertaking various hedge transactions. The Company also assesses whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in cash flows of hedged items. When it is determined that a derivative is not highly effective as a hedge, the Company discontinues hedge accounting prospectively. Cash flows resulting from hedging transactions are classified in the consolidated statements of cash flows in the same category as the cash flows from the item being hedged.

I. Comprehensive Income

Comprehensive (loss) income for the three and nine month periods ended June 30, 2007 and 2006 is as follows:

| | For the Three Months Ended June 30, | | For the Nine Months Ended June 30, | |
|--|--|----------|---------------------------------------|----------|
| | 2007 | 2006 | 2007 | 2006 |
| Net (loss) income | \$ (459) | \$ 1,669 | \$ 543 | \$ 5,693 |
| Unrealized gains (losses) on value of derivative securities, net of tax | 61 | 36 | (25) | (29) |
| Net unrealized investment gains (losses), net of tax | 3 | (13) | 51 | (52) |
| Foreign currency translation adjustments | 29 | 305 | 432 | 265 |
| Comprehensive (loss) income | \$ (366) | \$ 1,997 | \$ 1,001 | \$ 5,877 |

Table of Contents**J. Geographic Segment Information**

The Company reports a single Test and Measurement segment. Our net sales and long-lived assets by geographic area are presented below. The basis for attributing revenues from external customers to a geographic area is the location of the customer.

| | For the Three Months Ended June 30, | | For the Nine Months Ended June 30, | |
|----------------|--|-----------|---------------------------------------|------------|
| | 2007 | 2006 | 2007 | 2006 |
| Net sales: | | | | |
| United States | \$ 9,654 | \$ 11,663 | \$ 26,972 | \$ 33,569 |
| Other Americas | 888 | 1,442 | 3,434 | 4,028 |
| Germany | 3,715 | 5,826 | 13,724 | 14,646 |
| Other Europe | 7,172 | 7,600 | 22,008 | 23,389 |
| Japan | 3,207 | 3,341 | 13,236 | 12,230 |
| Other Asia | 8,810 | 8,555 | 28,028 | 26,034 |
| | \$ 33,446 | \$ 38,427 | \$ 107,402 | \$ 113,896 |

Other Asia net sales include \$4,607 and \$12,634 for China for the third quarter and first nine months of fiscal year 2007, respectively. Net sales to China were not material for the prior year's fiscal periods.

| | At June 30, | | At September |
|--------------------|-------------|-----------|--------------|
| | 2007 | 2006 | 30, 2006 |
| Long-lived assets: | | | |
| Americas | \$ 31,341 | \$ 26,015 | \$ 30,246 |
| Germany | 5,828 | 5,063 | 5,406 |
| Other | 1,185 | 925 | 921 |
| | \$ 38,354 | \$ 32,003 | \$ 36,573 |

K. Guarantor's Disclosure Requirements*Guarantee of original lease*

The Company has assigned the lease of its former office space in Reading, Great Britain to a third party. If the third party defaults on the monthly lease payments, the Company would be responsible for the payments until the lease expires on July 14, 2009. If the third party were to default, the maximum amount of future payments (undiscounted) the Company would be required to make under the guarantee would be approximately \$471 through July 14, 2009. The Company has not recorded any liability for this item, as it does not believe that it is probable that the third party will default on the lease payments.

Product Warranties

Generally, the Company's products are covered under a one-year warranty; however, certain products are covered under a two or three-year warranty. It is the Company's policy to accrue for all product warranties based upon historical in-warranty repair data. In addition, the Company accrues for specifically identified product performance issues. The Company also offers extended warranties for certain of its products for which revenue is recognized over the life of the contract period. The costs associated with servicing the extended warranties are expensed as incurred. The revenue, as well as the costs related to the extended warranties, is immaterial for the three and nine month periods ending June 30, 2007 and 2006.

A reconciliation of the estimated changes in the aggregated product warranty liability for the three and nine month periods ending June 30, 2007 and 2006 is as follows:

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| | For the Three Months Ended June 30, | | For the Nine Months Ended June 30, | |
|--|--|--------|---------------------------------------|----------|
| | 2007 | 2006 | 2007 | 2006 |
| Beginning balance | \$ 992 | \$ 910 | \$ 869 | \$ 1,084 |
| Accruals for warranties issued during the period | 875 | 411 | 245 | 1,069 |
| Accruals related to pre-existing warranties (including changes in estimates and expiring warranties) | (105) | (19) | (73) | (174) |
| Settlements made (in cash or in kind) during the period | (1,051) | (312) | (330) | (989) |
| Ending balance | \$ 711 | \$ 990 | \$ 711 | \$ 990 |

L. Pension Benefits

The Company has noncontributory defined benefit pension plans covering all of its eligible employees in the United States and certain non-U.S. employees. Pension benefits are based upon the employee's length of service and a percentage of compensation above certain base levels. A summary of the components of net periodic pension cost based upon a measurement date of June 30, 2006 for the three and nine month periods ending June 30, 2007 and 2006 is shown below:

| | United States Plan For the Three Months Ended June 30, | | Non U.S. Plan For the Three Months Ended June 30, | |
|---|--|--------|---|--------|
| | 2007 | 2006 | 2007 | 2006 |
| Service costs-benefits earned during the period | \$ 355 | \$ 409 | \$ 61 | \$ 55 |
| Interest cost on projected benefit obligation | 550 | 500 | 84 | 70 |
| Expected return on plan assets | (782) | (723) | (16) | (20) |
| Net loss recognition | 16 | 110 | 1 | |
| Amortization of transition asset | | (2) | 5 | 5 |
| Amortization of prior service cost | 45 | 45 | 2 | 2 |
| Net periodic benefit cost | \$ 184 | \$ 339 | \$ 137 | \$ 112 |

| | United States Plan For the Nine Months Ended June 30, | | Non U.S. Plan For the Nine Months Ended June 30, | |
|---|---|----------|--|--------|
| | 2007 | 2006 | 2007 | 2006 |
| Service costs-benefits earned during the period | \$ 1,065 | \$ 1,230 | \$ 179 | \$ 159 |
| Interest cost on projected benefit obligation | 1,652 | 1,500 | 246 | 203 |
| Expected return on plan assets | (2,347) | (2,168) | (48) | (59) |
| Net loss recognition | 49 | 329 | 2 | |
| Amortization of transition asset | | (7) | 17 | 16 |
| Amortization of prior service cost | 134 | 134 | 4 | 4 |
| Net periodic benefit cost | \$ 553 | \$ 1,018 | \$ 400 | \$ 323 |

The Company made a contribution of \$1,500 to its United States plan during the third quarter of fiscal 2007. We expect to contribute another \$500 to \$1,500 during the fourth quarter of fiscal 2007.

The Company also has an unfunded supplemental retirement plan (SERP) for former key employees, which includes retirement, death and disability benefits. Net periodic benefit cost for this plan was not material to the Company's consolidated financial statements for the three and nine month periods ended June 30, 2007 and 2006.

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M. Income Taxes

For the nine months ended June 30, 2007, the Company recorded a tax benefit of \$2,543 on a loss before taxes of \$2,000 resulting in an effective tax benefit rate of 127.2 percent, as compared with income tax expense of \$1,666 on income before taxes of \$7,359 or an effective tax rate of 22.6 percent for the same period in the prior year.

During the 2007 first quarter, the Company recorded a favorable discrete tax adjustment of \$882 associated with the retroactive application of research tax credits for the period of January 1, 2006 through September 30, 2006. This benefit was not recognized during the fiscal year ended September 30, 2006 as the research tax credit had expired and was not extended until December of 2006. Without regard to discrete items, such as the prior year research tax credit, the tax benefit rate for the nine months ended June 30, 2007 would have been 85.0 percent.

For the first nine months of fiscal year 2007, the effective tax benefit rate was higher than the U.S. federal statutory tax rate due to the favorable impacts from the research tax credit, extraterritorial income exclusion on U.S. exports and the impact of these benefits relative to a loss. These benefits were partially offset by the net U.S. tax on foreign remittances, effective tax rates in foreign jurisdictions that are higher than the U.S. statutory tax rate, and the net impact of other permanent differences.

The rate in 2006 is lower than the statutory rate primarily due to extraterritorial income exclusion benefits, a favorable adjustment in the valuation allowance for the utilization of foreign tax credits, and the reduction of certain tax reserves. The effective tax rate for fiscal year 2006 includes only one quarter of research tax credits.

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

This Management's Discussion and Analysis of Financial Condition and Results of Operations is intended to provide investors with an understanding of the Company's operating performance and financial condition. A discussion of our business, including our strategy, products, and competition is included in Part I of our 2006 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. For the first nine months of fiscal 2007, semiconductor customer orders comprised approximately 35 percent of our total, wireless communications customer orders were approximately ten percent of the total, precision electronic components and subassembly manufacturers' orders were approximately 25 percent of the total, and research and education customer orders were approximately 20 percent of the total. The remainder of our 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.

The most important factors influencing our ability to grow revenue are (i) our customers' spending patterns as they invest in new capacity or upgrade their lines for their new product offerings, (ii) our ability to offer interrelated products with differentiated value that solve our customers' most compelling test challenges, and (iii) our success in penetrating key accounts with our globally deployed sales and service team. We continue to believe that our strategy of pursuing a focused set of applications will allow us to grow faster than the overall test and measurement industry. Many of the industries we serve, including but not limited to the semiconductor industry, the wireless communications industry, and precision electronic components and subassembly manufacturers, have historically been very cyclical and have experienced periodic downturns. We began experiencing a softening in orders during the second quarter of fiscal 2007 reflecting our customers' cautious attitude with regard to capital equipment spending. We believe that this cautious attitude among our customers continued during our third quarter. Last quarter we communicated that we believed we were not in an industry wide downturn; however, our recent order levels indicate that semiconductor capital equipment providers are in a more significant downturn than we expected. We communicated that we would reduce our discretionary spending and we did achieve our anticipated costs reductions in selling, general and administrative costs during the third quarter. We are disappointed that our new product development spending was higher than we had planned, and we expect in the coming quarter for those costs to return to the level we experienced in the fourth quarter of the prior year. We believe that new product development is important, and we remain committed to maintain the necessary resources to implement our strategy in the short-term to successfully introduce our new product launches that we have planned through the remainder of calendar 2007.

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 strongly enhanced by deploying our own employees throughout the Americas, Europe and 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.

Critical Accounting Policies and Estimates

Management has identified critical accounting policies. These policies have the potential to have a more significant impact on our financial statements, either because of the significance of the financial statement item to which they relate or because they require judgment and estimation due to the uncertainty involved in measuring, at a

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specific point in time, events which will be settled in the future. These critical accounting policies and estimates are described in Management's Discussion and Analysis included in our 2006 Form 10-K, and include use of estimates, revenue recognition, inventories, income taxes, pension plan and a fuller description of stock compensation plans.

Stock compensation plans:

During the second quarter of fiscal year 2007, we revised our estimate of the expected life of stock options from 4.5 years in fiscal 2006 to 4.75 years for fiscal year 2007. In revising this estimate, we considered several factors, including the historical option exercise behavior of our employees, historical cancellation rates of past options, and the current life of options outstanding and vested. Our review of our most current data indicates that our average expected option life is 4.75 years. SFAS No. 123R also requires us to estimate an expected forfeiture rate when recognizing compensation cost. In the past we had used an 8% forfeiture rate for all stock options, performance award units, and restricted award units. Beginning in the second quarter of fiscal year 2007, we revised our estimated forfeiture rate for stock options to 3% and for performance award units to 5%. Our review of our most current data indicates that the rates as adjusted are more indicative of expected future expense. The resulting cumulative adjustment recorded during our second quarter of 2007 for the change in rates was not material to our financial results.

Results of Operations**Third Quarter Fiscal 2007 Compared with Third Quarter Fiscal 2006**

Net sales of \$33,446 for the third quarter of fiscal 2007 decreased 13 percent as compared to the prior year's third quarter sales of \$38,427. The effect of a weaker U.S. dollar positively impacted sales growth by approximately one percentage point. Geographically, sales decreased 20 percent in the Americas, 19 percent in Europe, and were up one percent in Asia. On a sequential basis, sales increased two percent from the second quarter of fiscal year 2007. Orders of \$36,006 for the third quarter decreased 17 percent compared to last year's orders of \$43,215. Geographically, orders decreased 23 percent in the Americas, 36 percent in Europe, and increased eight percent in Asia. Orders from the Company's semiconductor customers decreased approximately 30 percent, orders from wireless communications customers decreased approximately ten percent, orders from precision electronic component and subassembly manufacturers decreased approximately ten percent, and research and education customer orders increased approximately 20 percent compared to the prior year's third quarter. Sequentially, orders increased eight percent from the second quarter of fiscal 2007, primarily due to an increase in orders from semiconductor customers. Order backlog increased \$2,586 during the quarter to \$16,038 at June 30, 2007. The Company does not track net sales in the same manner as it tracks orders by major customer group. However, sales trends generally correlate to Company order trends although they may vary between quarters depending upon the orders which remain in backlog. Cost of goods sold as a percentage of net sales increased to 42.0 percent from 39.0 percent in the prior year's third quarter. The increase was due to an unfavorable product mix and fixed manufacturing costs being spread over lower sales volume. This was partially offset by a four percent weaker U.S. dollar. Nearly all products the Company sells are manufactured in the United States; therefore, cost of goods sold expressed in dollars is generally not affected by changes in foreign currencies. However, as a percentage of net sales, it is affected as net sales dollars fluctuate due to currency exchange rate changes. The effect of foreign exchange hedging on cost of goods sold was not material in either the third quarter of fiscal 2007 or fiscal 2006.

Selling, general and administrative expenses of \$15,288, or 45.7 percent of net sales, decreased \$560, or four percent, from \$15,848, or 41.2 percent of net sales, in last year's third quarter. We achieved the cost reduction goals we set for ourselves in March by reducing our discretionary spending. Compared to the prior year, the decrease in spending was due to lower costs for employee benefits, marketing communication programs, bonuses, and consultant and temporary help. This was partially offset by higher salary costs due to increased headcount particularly in our sales organization in Asia, and higher costs in Europe and Asia due to the weaker U.S. dollar.

Product development expenses for the quarter were \$7,116, or 21.3 percent of net sales, up \$759, or 12 percent, from last year's \$6,357, or 16.5 percent of net sales. The increase is primarily a result of our increased investment in product development activities to expand our product offering and accelerate the development of new products.

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The Company reported an operating loss for the third quarter of fiscal 2007 of \$3,017 compared to operating income of \$1,222 for the prior year's quarter. Lower sales and higher product development expenses accounted for the decrease.

Investment income was \$582 for the quarter compared to \$510 in last year's third quarter primarily as a result of higher interest rates.

The Company recorded an income tax benefit at an 81.2 percent rate and income tax expense at a 3.5 percent rate for the third quarter of fiscal 2007 and 2006, respectively. The effective tax rate (benefit) in 2007 is higher than the U.S. federal statutory tax rate due to the favorable benefits from the research tax credit, extraterritorial income exclusion on U.S. exports and the impact of these benefits relative to a loss. These benefits were partially offset by the net U.S. tax on foreign remittances, effective tax rates in foreign jurisdictions that are higher than the U.S. statutory tax rate, and the net impact of other permanent differences. The rate in 2006 is lower than the statutory rate primarily due to extraterritorial income exclusion benefits, an adjustment in the valuation allowance for the utilization of foreign tax credits, and the reduction of certain tax reserves.

The Company reported a net loss for the quarter of \$459, or \$0.03 per share, compared to net income of \$1,669, or \$0.10 per diluted share, in last year's third quarter. Lower sales were partially offset by a more favorable tax rate and lower operating costs, as described above.

Nine Months Ended June 30, 2007 Compared with Nine Months Ended June 30, 2006

Net sales of \$107,402 for the nine months ended June 30, 2007 decreased six percent from \$113,896 reported for the nine month period last year. The effect of a five percent weaker U.S. dollar was negligible on sales growth.

Geographically, net sales were down 19 percent in the Americas, six percent in Europe, and up eight percent in Asia.

Orders of \$106,235 for the nine months ending June 30, 2007 decreased ten percent from \$117,642 last year.

Geographically, orders decreased 25 percent in the Americas, 22 percent in Europe, and increased 19 percent in Asia.

Orders from the Company's semiconductor customers decreased approximately 30 percent, orders from wireless communications customers and precision electronic component/subassembly manufacturers were essentially flat, and research and education customer orders increased approximately 15 percent compared to the prior year's nine month period. See the Business Overview section of Management's Discussion and Analysis of Financial Condition and Results of Operations for a breakout of the first nine months of fiscal 2007 orders by major industry group.

Cost of goods sold as a percentage of net sales increased to 40.5 percent from 38.7 percent for the nine month period last year. The increase was due primarily to an unfavorable product mix and fixed manufacturing costs being spread over lower sales volume. The effect of foreign exchange hedging on cost of goods sold was not material in either period.

Selling, general and administrative expenses of \$48,255, or 44.9 percent of net sales, increased four percent, from \$46,557, or 40.9 percent of net sales, in the same period last year. The majority of the increase was due to costs associated with the stock option investigation and shareholder litigation, and higher salaries due to increased headcount. These costs were partially offset by lower benefit and bonus expenses.

Product development expenses for the first nine months of fiscal 2007 of \$19,363, or 18.0 percent of sales, were up 12 percent, from \$17,343, or 15.1 percent of net sales, for the same period last year. The increase was primarily a result of our increased investment in product development activities to expand our product offering and accelerate the development of new products.

Investment income during the first nine months of fiscal 2007 was \$1,715 versus \$1,422 for the same period in the prior year, primarily as a result of higher interest rates.

For the nine months ended June 30, 2007, we recorded a tax benefit of \$2,543 on a loss before taxes of \$2,000 resulting in an effective tax benefit rate of 127.2 percent, as compared with income tax expense of \$1,666 on income before taxes of \$7,359 or an effective tax rate of 22.6 percent for the same period in the prior year. During the 2007 first quarter, we recorded a favorable discrete tax adjustment of \$882 associated with the retroactive application of research tax credits for the period of January 1, 2006 through September 30, 2006. This benefit was

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not recognized during the fiscal year ended September 30, 2006 as the research tax credit had expired and was not extended until December of 2006. Without regard to discrete items, such as the prior year research tax credit, the tax benefit rate for the nine months ended June 30, 2007 would have been 85.0 percent. For the first nine months of fiscal year 2007, the effective tax rate (benefit) was higher than the U.S. federal statutory tax rate due to the favorable impacts from the research tax credit, extraterritorial income exclusion on U.S. exports and the impact of these benefits relative to a loss. These benefits were partially offset by the net U.S. tax on foreign remittances, effective tax rates in foreign jurisdictions that are higher than the U.S. statutory tax rate, and the net impact of other permanent differences. The effective tax rate for fiscal year 2006 includes only one quarter of research tax credits. The rate in 2006 is lower than the statutory rate primarily due to extraterritorial income exclusion benefits, a favorable adjustment in the valuation allowance for the utilization of foreign tax credits, and the reduction of certain tax reserves.

Net income for the first nine months of fiscal 2007 was \$543, or \$0.03 per diluted share, compared with net income of \$5,693, or \$0.34 per diluted share, last year. Lower sales and higher operating costs, partially offset by favorable tax items accounted for the decrease.

Financial Condition, Liquidity and Capital Resources***Working Capital***

The following table summarizes working capital as of June 30, 2007 and September 30, 2006:

| | June 30 | September 30 |
|--------------------------------------|-----------|-----------------|
| Current assets: | | |
| Cash and cash equivalents | \$ 14,262 | \$ 10,501 |
| Short-term investments | 33,049 | 36,203 |
| Refundable income taxes | 393 | 583 |
| Accounts receivable and other, net | 19,607 | 26,836 |
| Total inventories | 13,891 | 14,647 |
| Deferred income taxes | 3,913 | 4,206 |
| Prepaid expenses | 1,898 | 1,664 |
| | | |
| Total current assets | 87,013 | 94,640 |
| | | |
| Current liabilities: | | |
| Short-term debt | 21 | 872 |
| Accounts payable | 7,595 | 8,033 |
| Accrued payroll and related expenses | 4,510 | 6,089 |
| Other accrued expenses | 3,780 | 4,870 |
| Income taxes payable | 1,729 | 2,733 |
| | | |
| Total current liabilities | 17,635 | 22,597 |
| | | |
| Working capital | \$ 69,378 | \$ 72,043 |

Working capital decreased during the first nine months of fiscal 2007 by \$2,665. Accounts receivable and other, net decreased \$7,229 during the first nine months of fiscal year 2007, due primarily to lower sales during the June quarter versus the September quarter and lower days sales outstanding at June 30, 2007 of 46 versus 53 at September 30, 2006. Accounts payable decreased due to lower purchases resulting from our lower sales volume. Accrued payroll and related expenses decreased primarily due to the cash payment of fiscal 2006 annual incentive compensation and lower

similar accruals for the first nine months of fiscal 2007. Significant changes in cash and cash equivalents and short-term investments are discussed in the Sources and Uses of Cash section below.

Table of Contents*Sources and Uses of Cash*

The following table is a summary of our Condensed Consolidated Statements of Cash Flows:

| | Nine Months Ended June 30 | |
|-----------------------------|---------------------------|----------|
| | 2007 | 2006 |
| Cash provided by (used in): | | |
| Operating activities | \$ 5,373 | \$ 5,132 |
| Investing activities | 178 | (8,219) |
| Financing activities | (1,997) | (3,023) |

Operating activities. Cash provided by operating activities was \$5,373 for the nine months of fiscal year 2007 compared to \$5,132 in same period last year. Cash provided by operating activities is net earnings adjusted for certain non-cash items and changes in assets and liabilities.

During the first nine months of 2007, operating cash flows resulted primarily from a decrease in accounts receivable, the positive impact of non-cash charges for depreciation and stock-based compensation, and a decrease in inventory during the period. This was partially offset by decreases in current accrued liabilities. Additionally, the Company contributed \$1,500 to its U.S. Pension plan. Other adjustments to reconcile net earnings to net cash provided by operating activities are presented on the Condensed Consolidated Statements of Cash Flows.

During the first nine months of 2006, operating cash flows resulted primarily from net earnings and the positive impact of non-cash charges, partially offset by increases in accounts receivable and inventory.

Investing activities. Net cash provided by investing activities was \$178 for the first nine months of 2007 as compared to cash used in investing activities of \$8,219 for the same period last year. Cash flows from our investing activities for the first nine months of the current year were the result of a net sale of marketable securities of \$3,232 versus a net purchase of \$4,276 in the prior year, and lower capital expenditures. Short-term investments totaled \$33,049 at June 30, 2007 as opposed to \$45,068 at the same time last year.

Financing activities. Cash used in financing activities was \$1,997 in the first nine of fiscal year 2007 compared to \$3,023 last year. During the current year's nine-month period, we repaid \$857 of short-term debt versus borrowing \$990 of short-term debt in the prior year. Short-term debt at June 30, 2007 totaled \$21 versus \$1,004 at June 30, 2006. During the 2006 period, we repurchased 215,000 Common Shares for \$2,711, at an average price of \$12.61 per share including commissions (see Note F).

We expect to finance capital spending, working capital requirements and the stock repurchase program with cash and short-term investments on hand, available lines of credit, and cash provided by operations. At June 30, 2007, the Company had total unused lines of credit with domestic and foreign banks aggregating \$14,276 of which \$10,000 was long-term and \$4,276 was a combination of long-term and short-term depending upon the nature of the indebtedness. See Note G.

Outlook

We continue to believe that our strategy of pursuing a focused set of applications will allow us to grow faster than the overall test and measurement industry. Our ability to grow revenue is dependent upon our customers' spending patterns, our ability to offer interrelated products with differentiated value that solve our customers' most compelling test challenges, coupled with our success in penetrating key accounts with our globally deployed sales and service team. We expect new product development costs for the fourth quarter of fiscal 2007 to approximate those in the prior year's fourth quarter as we continue to build a stronger, broader and more complete product offering for our customers. We remain committed to introducing a number of new products by the end of this calendar year, which we believe will provide incremental sales growth in 2008.

Our customers are particularly uncertain with regards to their capital spending; consequently, our visibility for future results is more limited than usual. The Company expects sales for the fourth quarter of fiscal 2007, which will end September 30, 2007, to range between \$31,000 and \$38,000. Results will range from a pretax loss to pretax earnings in the single digits as a percentage of net sales. The Company expects the effective tax rate for the remainder of fiscal 2007 to approximate the statutory rate, although the rate will fluctuate based on actual results.

Table of Contents**Recent Accounting Pronouncements**

In February 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments, which amends SFAS 133 Accounting for Derivative Instruments and Hedging Activities and SFAS 140 Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. SFAS No. 155 simplifies the accounting for certain derivatives embedded in other financial instruments by allowing them to be accounted for as a whole if the holder elects to account for the whole instrument on a fair value basis. SFAS No. 155 also clarifies and amends certain other provisions of SFAS No. 133 and SFAS No. 140. SFAS No. 155 is effective for all financial instruments acquired, issued or subject to a remeasurement event occurring in fiscal years beginning after September 15, 2006. The adoption of SFAS No. 155 did not have a material impact on our consolidated financial statements.

In July 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes and Interpretation of FASB Statement 109. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. It also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006, although early adoption is encouraged. The Company is currently evaluating the impact of this Interpretation on its financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the Board having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently evaluating the impact of this Statement on its financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin (SAB) No. 108 regarding the process of quantifying financial statement misstatements. SAB No. 108 states that registrants should use both a balance sheet approach and an income statement approach when quantifying and evaluating the materiality of a misstatement. The interpretations in SAB No. 108 contain guidance on correcting errors under the dual approach, and provide transition guidance for correcting errors. This interpretation does not change the requirements within SFAS No. 154, Accounting Changes and Error Corrections a replacement of APB No. 20 and FASB Statement No. 3, for the correction of an error on financial statements. SAB No. 108 is effective for annual financial statements covering the first fiscal year ending after November 15, 2006. The adoption of SAB No. 108 is not expected to have a material impact on our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R). SFAS No. 158 represents the completion of the first phase in the FASB s postretirement benefits accounting project and requires an employer that is a business entity and sponsors one or more single employer benefit plans to (1) recognize the over-funded or under-funded status of the benefit plan in its statement of financial position, (2) recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs of credits that arise during the period but are not recognized as components of net periodic benefit cost, (3) measure defined benefit plan assets and obligations as of the end of the employer s fiscal year, and (4) disclose in the notes to financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation. The provisions of SFAS No. 158 are effective as of September 30, 2007, except for the measurement date provisions, which are effective for fiscal years ending after December 15, 2008. The impact of adopting SFAS No. 158 cannot be determined until the actuarial valuations are completed and the plan asset values are determined for the current year ending September 30, 2007. However, based upon the funded status of the Company s pension plans at September 30, 2006, the adoption of SFAS No. 158 would have reduced total stockholders equity by approximately \$6,109 on a pretax basis at September 30, 2006. By the time we adopt SFAS No. 158 as of September 30, 2007, plan performance and actuarial assumptions

could have a significant impact on the actual amounts recorded.

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In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* including an amendment of FAS 115. SFAS No. 159 allows companies to choose, at specified election dates, to measure eligible financial assets and liabilities at fair value that are not otherwise required to be measured at fair value. Unrealized gains and losses shall be reported on items for which the fair value option has been elected in earnings at each subsequent reporting date. SFAS No. 159 also establishes presentation and disclosure requirements. It is effective for fiscal years beginning after November 15, 2007 and will be applied prospectively. The adoption of SFAS No. 159 is not expected to have a material impact on our consolidated financial statements.

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk.

The Company is exposed to a variety of risks, including foreign currency fluctuations, interest rate fluctuations and changes in the market value of its short-term investments. In the normal course of business, we employ established policies and procedures to manage our exposure to fluctuations in foreign currency values and interest rates.

The Company is exposed to foreign currency exchange rate risk primarily through transactions denominated in foreign currencies. We currently utilize foreign exchange forward contracts or option contracts to sell foreign currencies to fix the exchange rates related to near-term sales and effectively fix our margins. Generally, these contracts have maturities of three months or less. Our policy is to only enter into derivative transactions when we have an identifiable exposure to risk, thus not creating additional foreign currency exchange rate risk. In our opinion, a 10 percent adverse change in foreign currency exchange rates would not have a material effect on these instruments and therefore our results of operations, financial position or cash flows.

The Company maintains a short-term investment portfolio consisting of United States government backed notes and bonds, corporate notes and bonds, and mutual funds consisting primarily of government notes and bonds. An increase in interest rates would decrease the value of certain of these investments. However, in management's opinion, a 10 percent increase in interest rates would not have a material impact on our results of operations, financial position or cash flows.

ITEM 4. Controls and Procedures.

The Company has evaluated, under the supervision and with the participation of the Company's Chief Executive Officer and Chief Financial Officer, the design and operation of the Company's disclosure controls and procedures as of June 30, 2007 pursuant to Rule 13a-15(b) under the Securities Exchange Act of 1934. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures are effective in ensuring that information required to be disclosed in the reports it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities Exchange Commission's rules and forms, and that information was accumulated and communicated to the Company's management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

There were no changes in the internal control over financial reporting that occurred during the third quarter of fiscal 2007 that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

PART II. OTHER INFORMATION**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

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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 during 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 nearly three-fourths of our revenue during the first nine months of fiscal 2007. 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 June 30, 2007, 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.

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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. Our results could be adversely affected if we are unable to implement further system upgrades and enhancements without significant interruptions in accounting systems, order entry, billing, manufacturing and other customer support functions. We also have outsourced the hosting of these systems to a third-party vendor located in Texas. If our third-party vendor experiences shut 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.

Planned cost savings initiatives

In March 2007, we began the implementation of operating cost reductions that will impact our cost structure during the second half of fiscal 2007. Our financial results could be negatively affected if we are unable to continue to effectively implement the planned cost savings over the remainder of the fiscal year. Additionally, our ability to grow our sales in the future could be negatively affected if our cost savings initiatives have an adverse effect on our ability to develop new products.

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. The awards issued in fiscal year 2007 are similar to those issued in 2006; however, they can only be adjusted in 25 percent increments. We currently are 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 have experienced substantial additional costs due to the previously announced independent investigation into our past stock option grant practices that was conducted by a Special Committee of our Board of Directors. As disclosed under Legal Proceedings Stock Option Matters, in our 2006 Form 10-K, 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, disgorgement 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

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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, our ability to work with third parties to augment our product offering, 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 2. Unregistered Sales of Equity Securities and Use of Proceeds.

On February 12, 2007, the Company announced its Board of Directors had approved an open market stock repurchase program (the 2007 Program). Under the terms of the 2007 Program, the Company may purchase up to 2,000,000 Common Shares, which represents approximately 12 percent of its total outstanding Common Shares, through February 28, 2009. The 2007 Program replaces the prior repurchase program, which expired on December 31, 2006. The purpose of the 2007 and prior programs is and was to offset the dilutive effect of stock option and stock purchase plans, and to provide value to shareholders. Common Shares held in treasury may be reissued in settlement of stock purchases under these plans. The Company made no share repurchases during the first nine months of fiscal 2007 and repurchased 215,000 shares at an average cost, including commissions of \$12.61 during the nine month period of fiscal 2006. See Notes to Condensed Consolidated Financial Statements Note F.

Item 6. Exhibits.

(a) Exhibits. The following exhibits are filed herewith:

Exhibit

| Number | Exhibit |
|--------|--|
| 31(a) | Certification of Joseph P. Keithley pursuant to Rule 13a-14(a)-15d-14(a). |
| 31(b) | Certification of Mark J. Plush pursuant to Rule 13a-14(a)-15d-14(a). |
| 32(a)+ | Certification of Joseph P. Keithley pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350. |
| 32(b)+ | Certification of Mark J. Plush pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350. |

+ The certifications furnished pursuant to this item will not be deemed filed for purposes of Section 18 of the Exchange Act (15 U.S.C. 78r), or otherwise subject to the liability of that section. Such certification will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that the registrant specifically incorporates it by reference.

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SIGNATURES

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

KEITHLEY INSTRUMENTS, INC.
(Registrant)

Date: August 9, 2007

/s/ Joseph P. Keithley
Joseph P. Keithley
Chairman, President and Chief Executive
Officer
(Principal Executive Officer)

Date: August 9, 2007

/s/ Mark J. Plush
Mark J. Plush
Vice President and Chief Financial Officer
(Principal Financial and Accounting
Officer)