KEY TECHNOLOGY INC
Form 10-K
December 14, 2007

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

FORM 10-K

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934
for the fiscal year ended September 30, 2007

or

x TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934
For the transition period from ____ to ____ .
Commission File No. 0-21820

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

Oregon	**93-0822509**
(State or jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
150 Avery Street **Walla Walla, Washington** (Address of Principal Executive Offices)	**99362** (Zip Code)

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

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, no par value	Nasdaq Global Market

Securities registered pursuant to Section 12(g) of the Act:
None

Indicated by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities

Act. Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act Yes o No x

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Sections 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No 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 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. [ ]

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 Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer x	Non-accelerated filer o

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

The aggregate market value of the Registrant's common stock held by non-affiliates on March 31, 2007 (based on the last sale price of such shares) was approximately $77,689,216.

There were 5,552,697 shares of the Registrant's common stock outstanding on December 7, 2007.

DOCUMENTS INCORPORATED BY REFERENCE

Parts of Registrant's Proxy Statement dated on or about January 4, 2008 prepared in connection with the Annual Meeting of Shareholders to be held on February 6, 2008 are incorporated by reference into Part III of this Report.

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PART I

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

Forward-looking statements are subject to a number of risks and uncertainties. The Company cautions investors not to place undue reliance on its forward-looking statements, which speak only as to the date on which they are made. Key's actual results may differ materially from those described in the forward-looking statements as a result of various factors, including those listed below:

- adverse economic conditions, particularly in the food processing industry, either globally or regionally, may adversely affect the Company's revenues;
- competition and advances in technology may adversely affect sales and prices;
- failure of the Company's new products to compete successfully in either existing or new markets;
- the limited availability and possible cost fluctuations of materials used in the Company's products could adversely affect the Company's gross profits;
- the inability of the Company to protect its intellectual property, especially as the Company expands geographically, may adversely affect the Company's competitive advantage; and
- intellectual property-related litigation expenses and other costs resulting from infringement claims asserted against the Company by third parties may adversely affect the Company's results of operations and its customer relations.

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

ITEM 1. BUSINESS.

General

The Company was founded in 1948 as a local producer of vegetable processing equipment. The Company has evolved into a worldwide supplier of process automation solutions to the food processing industry and other industries such as tobacco and pharmaceuticals. The present Company was incorporated in 1982 as a result of a management buyout of the predecessor organization.

The Company and its operating subsidiaries design, manufacture, sell and service process automation systems that process product streams of discrete pieces to improve safety and quality. These systems integrate electro-optical automated inspection and sorting systems with process systems that include specialized conveying and preparation equipment. The Company provides parts and service for each of its product lines to customers throughout the world.

Sales for the year ended September 30, 2007 were $107.5 million compared with $84.8 million for fiscal 2006. The Company reported net earnings for fiscal 2007 of $7.4 million, or $1.37 per diluted share, compared with a net loss of $793,000, or $0.15 per diluted share, for fiscal 2006. Export and international sales for the fiscal years ended

September 30, 2007, 2006 and 2005 accounted for 46%, 51% and 52% of net sales in each such year, respectively.

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Industry Background

Food Processing Industry

The Company's primary market is the food processing industry. Food processors must process large quantities of raw product through different stages, including sorting to remove foreign material and defective pieces, and inspection for product quality and safety. The frequency and severity of defects in the raw product is highly variable depending upon local factors affecting crops. Historically, defect removal and quality control in the food processing industry have been labor intensive and dependent upon and limited by the variability of the work force. The industry has sought to replace manual methods with automated systems that achieve higher yield, improve product quality and safety, and reduce costs.

The Company's strategy is to solve processing industry problems of high labor costs, inadequate yields and inconsistent quality and safety by providing automated inspection systems and process systems. The Company's process automation systems use advanced optical inspection technology to improve product yield (more of the good product recovered) and quality (higher percentage of defective product and foreign material removed) over the manual sorting and defect removal methods historically used by food processors. In more developed markets, such as those in North America and Western Europe, the substitution of automated inspection for manual inspection is well underway. However, processors in these areas remain keenly interested in process yield and product quality and safety improvements.

The largest markets for the Company's products have been processors of potatoes, vegetables, fruit and snack foods. The Company believes many additional applications for its systems exist in both food and non-food markets.

The principal potato market served by the Company's systems is french fries. French fries comprise approximately 90% of the over eight billion pounds of frozen potato products processed annually in the United States. The expansion of American-style fast food chains in other countries is beginning to result in development of the frozen french fry market overseas. Current domestic investment in new french fry processing facilities has flattened relative to historical levels, largely in response to changing consumer preferences. However, investments in process yield enhancement and in greater process throughputs from existing plants remain significant items for the Company and its customers in the potato market. The Company's recent diversification strategies have resulted in less dependence on this industry although it continues to be a strategically important market.

The Company's products are used in the fruit and vegetable processing market where field-harvested products are cleaned, graded, automatically sorted, blanched and processed prior to freezing, canning or packaging for sale to institutional and retail markets. Principal fruit and vegetable markets for the Company are green beans, corn, carrots, peas, onions, apples, pears, cranberries, peaches, pre-prepared, ready-to-eat salads and vegetables, dehydrated fruits and vegetables, and fresh-cut fruit products.

The global food processing industry has been in a consolidation period and market conditions suggest further consolidation in the future. The Company believes the resulting food processing companies are financially stronger, yet are faced with the need to improve profitability while satisfying external pressures to hold constant or reduce prices for their own products and provide safer products to the consuming public. Since the Company's equipment results in higher process yields, improved product quality and safety, as well as reduced processing costs, the Company believes these surviving companies will have increased interest in the Company's products to satisfy these needs, allowing for expanded sales into the food processing industry in future years. Due to the seasonal nature of the food processing industry, the Company does experience some seasonality of orders and shipments. Orders and shipments to this industry in the Company's first fiscal quarter of the year tend to be lower than during the Company's other fiscal quarters. Demand for the Company's products remained strong during fiscal 2007 due to positive market

conditions and new product introductions by the Company.

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Non-food Industries – Tobacco, Pharmaceuticals and Nutraceuticals

Processors in non-food industries also implement systems solutions to reduce costs, increase yields, and produce higher quality products. The Company's primary non-food markets are the tobacco industry and the pharmaceutical/nutraceutical industry.

In fiscal 2007, the tobacco industry represented a small share of the Company's sales. The Company's products provide tobacco companies sorting capability to remove foreign matter from a stream of stripped tobacco.

In fiscal 2007, the pharmaceutical and nutraceutical industries represented a small share of the Company's sales. However, to further its growth strategy, the Company continued to expand its line of automation solutions, introducing three new product lines to provide more comprehensive solutions to its customers.

Products

The following table sets forth sales by product category for the periods indicated:

	Fiscal Year Ended September 30,					
	2007		2006		2005	
	(in thousands)					
Automated inspection systems	$ 46,858	44%	$ 30,264	36%	$ 27,284	34%
Process systems	40,947	38%	34,925	41%	31,853	40%
Parts and service/contracts	19,735	18%	19,651	23%	21,185	26%
Net sales	$ 107,540	100%	$ 84,840	100%	$ 80,322	100%

Service and maintenance contracts are less than 10% of total net sales and are therefore summarized with parts and service/contracts.

The following table sets forth the percent of the total gross margin contributed by each product category for the periods indicated:

	Fiscal Year Ended September 30,		
	2007	2006	2005
Automated inspection systems	51%	44%	41%
Process systems	30%	30%	28%
Parts and service/contracts	19%	26%	31%
Total gross margin	100%	100%	100%

Upgrades of automated inspection systems are included with automated inspection systems.

Automated Inspection Systems

Automated inspection systems are used in various applications to detect and eliminate defects and foreign materials, most often during processing of raw and semi-finished products. The Company's product families within this group include the following: ADR® automatic defect removal systems used in the french fry industry; Tobacco Sorter™3 tobacco sorting systems used in tobacco threshing and primary processing; and the Tegra® and Optyx® sorter families which are used in a wide variety of applications in many industries and markets. All of the Company's automated inspection systems operate on Key's advanced G6 electro-optical platform, which features a controller,

modular vision engine and high-resolution cameras. The modular design and use of industry-wide connectivity standards ease future upgrades to keep the systems up to date and performing optimally as technology advances.

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Nearly all systems in this group use proprietary linear array, charged coupled device ("CCD") monochromatic, color or multi-spectral cameras. Each of the cameras scan the product-streams, which move at 5 to 20 feet per second, at the rate of 1,500 to 8,000 times per second and can identify defects as small as 1/128 of an inch (0.17 mm) in diameter. Systems with monochromatic cameras generally are sold at lower price levels and are most effective for product that has a marked disparity in shade between the defective and the good product. Systems with color cameras are required when a variety of defect and product colors occur simultaneously, when the difference in shading between the defective and the good product is more subtle, and where shape sorting is required. Multi-spectral systems can utilize infrared or ultraviolet technologies, individually or in combination with visible light, to identify defects that may not be detectable by using solely visible light spectra.

Tegra System. Tegra is the Company's highest capacity optical sorter and provides accurate in-air defect removal. Tegra incorporates object-based sorting technology that recognizes not only color and size, but also shape characteristics. This capability provides a solution to previously difficult sorting problems, such as differentiation between green beans and green bean stems. Tegra, as with all sorters, incorporates KeyWare® software that substantially reduces operational complexity. KeyWare consists of application packs, each specifically designed for a single product category that, together with the system's computer hardware capability and networking software, support all standard factory control and automation interfaces. These features allow Tegra to establish data connectivity and communication with a processing plant's computer network system. Certain present and potential applications for Tegra systems include potato products, green beans, dried beans, corn, carrots, peas, spinach and other leafy vegetables, pears, nuts, grains, coffee, recycled commodities such as paper and plastic, and tobacco.

Optyx System. The Optyx family of sorters provides a unique combination of on-belt and in-air sorting and offers multiple sensor capabilities with cameras, lasers, or a combination of cameras and lasers. The lower cost Optyx 3000 series has the power and sorting capabilities of a larger sorter in an economical and compact machine. It is ideal for smaller processors and lower volume processing lines which are unable to justify the expense of a larger sorter.

In 2005, Key added laser-sensing technology to its optical inspection capabilities, enabling improved foreign material detection and removal based on differences in the optical properties of materials, regardless of color. Raptor Laser Technology was first available in the Optyx 3000 Series Sorter, which combines Key's proprietary state-of-the-art G6 color cameras and powerful G6 sorting platform with laser technology. In fiscal 2006, the Company introduced Raptor Laser Technology in the high-volume Optyx 6000 Series Sorter. The larger Optyx 6000 series sorter provides customers with a mid-size sorting option with greater throughput. Featuring a doublewide platform that uses Key's G6 engine, Optyx 6000 Raptor detects the smallest defects and foreign material to optimize product quality and maximize food safety at double the throughput of an Optyx 3000. As the first wide-belt laser sorter to maintain the high resolution of the finest narrow-belt laser sorters, it can sort fresh, frozen and dried fruits and vegetables, including frozen potato products, tree nuts, raisins and other food products at production rates of up to 40,000 pounds (approximately 18 metric tons) per hour, depending on the application.

In 2007, FluoRaptor™ was added to the Optyx product family. FluoRaptor, a fluorescence-sensing laser, is designed to maximize the detection and removal of defects, extraneous vegetable matter, and foreign material (FM) based on differing levels of chlorophyll, and is ideal for the fresh-cut and vegetable industries.

Optyx series sorters employ a novel broad-band illumination system and are designed to require minimal maintenance. The Optyx line of sorters has gained strong acceptance in segments of the fruit, vegetable, processed potato, dried fruit and nut, and snack food markets. Additionally, Optyx has been placed in applications inspecting pharmaceuticals, nutraceuticals, plastics, tobacco, and paper.

Tobacco Sorter 3. The tobacco industry has special requirements in the handling and sorting of its tobacco products, which vary in size and moisture content and other properties depending upon the type of product being produced and

the point of handling and inspection. Key's Tobacco Sorter 3 (TS3), utilizes a specially constructed frame, enclosure, and material handling arrangement to meet the specific product inspection requirements of this industry. TS3 has been installed in North America, Latin America, Europe and Asia.

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ADR System. The Company's ADR systems are used to transport, inspect and remove defects from French fries. The Company believes its ADR system is the principal optical inspection and defect removal system used in the French fry processing industry. The Company's full-capacity ADR systems can process up to 27,000 pounds of product per hour. The most recent version, introduced in fiscal 2006, is ADR®5, a combination of the well-proven conveying and fry alignment system of ADR® III with the G6 engine, improved cutting subsystem and LED lighting including infrared. LED lighting provides a high level of output stability, both spectral and intensity, with extremely low maintenance cost. The improved cutting subsystem enables the system to cut excessively long fries to control product length, a function especially valuable for fast-food products. The ADR 5 system is available both as a new system as well as an upgrade to existing ADR® II and ADR III installations.

Pharmaceutical and Nutraceutical Inspection Systems. In fiscal 2007, the Company introduced the OptyxSG/P and OptyxSG/N inspection systems, the Impulse™ size grading system, and the PulseScrubber™ softgel polishing system.

Introduction of the OptyxSG/P enables the Company to offer a fully 21CFR11-compliant, high-volume inspection solution to solid dose pharmaceutical manufacturing. Applicable to OTC (over the counter) and prescription drugs, the OptyxSG/P meets validation requirements pharmaceutical customers face when selecting automation for their FDA-regulated production lines. The Company shipped the first OptyxSG/P in the third fiscal quarter. Also introduced in 2007 was the OptyxSG/N, a replacement for the original OptyxSG, targeted at the nutraceutical market. The /N version includes many of the features of the /P without the specific enhancements required for the regulated pharmaceutical market. The Company shipped the first OptyxSG/N in the fourth quarter of fiscal 2007.

With the introduction of the Impulse/P solid dose size grading product line, the Company continued to build toward a more comprehensive "full line" solution. The Impulse/P, derived from the Company's Impulse vibratory conveyor technology, provides high-volume vibratory size grading that complements other automation solutions like the OptyxSG-series. First shipments of the Impulse/P began in the third quarter of fiscal 2007.

The PulseScrubber product, introduced in the fourth quarter of fiscal 2007, is targeted at the softgel manufacturing segment and provides a fully-automated, high-volume continuous-flow alternative to traditional batch-oriented softgel polishing. The Company expects first shipments in early calendar 2008. Like the Impulse/P, the PulseScrubber complements other systems to provide customers the economic benefits of highly-integrated continuous automation.

The Company's Vantyx® inspection system is a product developed for inspection of blister-packed solid dose pharmaceuticals. Using patented spatial color analysis technology, this product line inspects solid-dose pharmaceuticals for broken or missing pieces, foreign products, discoloration or coating defects, as well as the integrity of capsules. The pharmaceutical inspection system also verifies and detects color, size, location and shape defects at processing rates of over one million pieces per hour.

Upgrades. The Company has a large installed base of inspection and processing systems. This installed base generates potential business for the Company's upgrade products. In contrast to the acquisition of new inspection and processing systems products, upgrades can provide the customer with a less capital intensive alternative.

The Company believes that there is an opportunity for the sale of upgrade product offerings to its customers so that newer technology with advanced features, lower cost, greater reliability, and performance enhancements can benefit owners of Key systems. The Company has increased its investment in development of specific upgrade products, particularly the G6 vision engine which creates upgrade opportunities for many customers in its installed base of sorting systems.

Process Systems

Conveying and process systems are utilized worldwide throughout processing industries to move and process product within a production plant. The Company's conveying and process systems include the SmartShaker® vibratory solutions of Iso-Flo® and Impulse™ branded conveyor systems, Farmco rotary grading systems, Turbo-

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Flo® steam blanchers, Forté™ Process Control systems, Freshline product family for fresh-cut, and additional conveying and processing equipment. The functions of these product lines include conveying, transferring, distributing, aligning, feeding, metering, separating and grading, as well as blanching, cooking, pasteurizing, cooling, cleaning, washing and drying. The process systems group includes standard products as well as custom designed equipment.

Iso-Flo Vibratory Conveying Systems. The Company's principal specialized conveying system is its Iso-Flo vibratory conveyor system. The Iso-Flo conveyor is a type of pan conveyor. Pan conveyors are common throughout industries that process product streams of discrete pieces, including the food processing industry. Pan conveyors move product pieces by vibrating the pan at high frequency along a diagonal axis, upward and forward. This action propels the product ahead in small increments and distributes it evenly for close control of movement and presentation.

Iso-Flo systems are used in a variety of processing applications, including potato products, vegetables and fruits (green beans, peas, carrots, corn, peaches, pears, cranberries and apples), snack foods, cereals, fresh salads, cheese, poultry, and seafood. Non-food processing applications include nutraceuticals, tobacco, pet food and plastics.

Impulse is a line of nearly silent electromagnetic vibratory conveyors which combine the advantage of quick start/stop with precise metering control. Additionally, the Impulse conveyor drive systems are oil-free, which limits the potential for contamination and improves the safety of food products. This conveyor system was developed for packaging applications in snack food, dry ingredient, chemical and pharmaceutical processing, but is seeing increased application in a wide variety of food and industrial processes.

Rotary grading systems. The mechanical sizing, sorting, separating, and grading products sold under the Farmco brand name are used in many food processing and fresh vegetable packing operations. These rotary sizing and grading technologies optimize yield, increase packaging efficiency, and improve product quality by either removing oversized, undersized and small irregular-shaped pieces of product from the line or separating product into predetermined size categories. In combination with other Company-provided equipment, these products increase overall line efficiency and systems capability.

Turbo-Flo and Preparation Systems. The Company designs and manufactures preparation systems to prepare products prior to cooking, freezing, canning or other processing. Products in this group include the Turbo-Flo Blancher/Cooker/Pasteurizer, air cleaners, air coolers, vegetable metering and blending systems, and bulk handling equipment. These products represent the Company's most mature product line. Sales of these products over the years have formed a customer base for sales of other Company products and are also establishing a customer base in developing geographic markets.

Preparation system revenues may also include a variety of third-party supplied equipment and installation services which are sold as components of larger processing lines, for which the Company has assumed turn-key sales responsibility. In addition, the process systems group includes other custom designed conveying and raw food sizing, grading, and preparation equipment.

Forté Control Systems. The Company's primary offering in the area of process control for processing systems, Forté, provides a foundation for a wide range of control options for processing lines, from simple on/off commands to data logging and recipe entry. This product is complementary to the Company's primary equipment lines.

Freshline products. The Company's product line addresses the fresh-cut food industry and includes high volume automatic dryers, as well as a range of processing solutions from individual machines to large-scale production lines with automated control systems.

Parts and Service/Contracts

The Company has a large installed base of inspection and processing systems. This installed base generates potential business for the Company's parts and service products. The Company has made parts and service an area

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of strategic focus, and realigned its organization to leverage the large installed base and its strong customer support organization.

The Company provides spare parts and post-sale field and telephone-based repair services to support its customers' routine maintenance requirements and seasonal equipment startup and winterization processes. The Company considers its parts and maintenance service sales to be important potential sources of future revenue growth. The Company continues to realign its service organization so that field service personnel are now geographically located closer to its customers throughout the world. This strategy has contributed to revenue growth and improved gross margins in parts and service. The Company also typically provides system installation support services which are included in the sales price of certain of its products, principally automated inspection systems, and customer training.

Engineering, Research and Development

At September 30, 2007, the Company's research and development department had 33 employees who conduct new product research and development and sustaining engineering for released products. The Company's technical staff includes electronic, optical, mechanical and software engineers, mathematicians and technical support personnel.

The Company's project engineering department had 46 employees engaged in project engineering for custom systems. The project engineering teams are responsible for engineering and designing the details of each custom order. A document control team maintains and controls product documentation and the product modeling database for the development engineering and project engineering teams as well as the manufacturing department.

In fiscal 2007, the Company's research and development expenses, together with engineering expenses not applied to the manufacturing costs of products, were approximately $5.5 million, compared to $6.4 million and $5.1 million in 2006 and 2005, respectively.

Manufacturing

The Company maintains two domestic manufacturing facilities, one located in Walla Walla, Washington and one in Redmond, Oregon. The Company also has a European manufacturing facility located in The Netherlands. The Company's current manufacturing facilities and its product design and manufacturing processes integrate Computer Aided Engineering (CAE), Finite Element Analysis (FEA), Computer Aided Design (CAD), Computer Aided Manufacturing (CAM) and Computer Integrated Manufacturing (CIM) technologies. Manufacturing activities include process engineering; fabrication, welding, finishing, and assembly of custom designed stainless steel systems; camera and electronics assembly; subsystem assembly; and system test and integration. The Company manufactures specific products in the following locations:

Location	Size in Square Feet	Products/Services Produced
Walla Walla, Washington	173,000	Automated Inspection Process Systems Parts and Service
Redmond, Oregon	19,000	Process Systems Parts and Service
Beusichem, The Netherlands	45,000	Process Systems Parts and Service
Beusichem, The Netherlands	18,000	Parts Warehouse Future Manufacturing Expansion

The Company manufactures certain of its products to Underwriters Laboratories and United States Department of Agriculture standards. Certain of the Company's products also comply with the Canadian Standards Association

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(CSA), European CE (Conformité Européene) and Electronic Testing Laboratory (ETL) safety standards. The Company's domestic facilities were recertified to the ISO 9001:2000 standard in 2006.

Certain components and subassemblies included in the Company's products are obtained from limited-source or sole-source suppliers. The Company attempts to ensure that adequate supplies are available to maintain manufacturing schedules. Although the Company seeks to reduce its dependence on limited- and sole-source suppliers, the partial or complete loss of certain sources of supply could have an adverse effect on the Company's results of operations and relations with customers. During fiscal 2007 and 2006, the Company experienced higher component costs and reduced margins on certain product lines due to the worldwide shortage of stainless steel.

Environmental

The Company has not received notice of any material violations of environmental laws or regulations in on-going operations at any of its manufacturing locations.

Sales and Marketing

The Company markets its products directly and through independent sales representatives. In North America, the Company operates sales offices in Walla Walla, Washington; Medford, Oregon; Redmond, Oregon; and Santiago de Querétaro, Mexico. The Company's subsidiary, Key Technology B.V., provides sales and service to European and Middle Eastern and South African customers. The Company's subsidiary, Key Technology Australia Pty Ltd., provides sales and service to customers primarily in Australia and New Zealand. The Company's subsidiary Productos Key Mexicana S. de R.L. de C.V. provides sales and service to customers in Mexico, Central and South America. The Company's subsidiary, Key Technology (Shanghai) Trading Company Ltd., provides sales and service to customers in greater China. The Company supplies products from both product groups - automated inspection systems and process systems - to customers in its primary markets through common sales and distribution channels. In addition, the Company supplies parts and service through its worldwide service organization.

Most exports of products manufactured in the United States for shipment into international markets other than Europe and Australia have been denominated in U.S. dollars. Sales into Europe of systems, spare parts and service, as well as products manufactured in Europe, are generally denominated in European currencies, most commonly Euros. Sales into Australia are typically denominated in its local currency. In its export and international sales, the Company is subject to the risks of conducting business internationally, including unexpected changes in regulatory requirements; fluctuations in the value of the U.S. dollar, which could increase or decrease the sales prices in local currencies of the Company's products in international markets; tariffs and other barriers and restrictions; and the requirements of complying with a variety of international laws. Additional information regarding export and international sales is set forth in Note 15 to the Company's Consolidated Financial Statements for the fiscal year ended September 30, 2007.

During fiscal 2007, 2006 and 2005, sales to our largest customer, McCain Foods, represented approximately 9%, 17% and 16% of total net sales, respectively. While the Company believes that its relationship with McCain is satisfactory, the loss of this customer could have a material adverse effect on the Company's revenues and results of operations.

Backlog

The Company's backlog as of September 30, 2007 and September 30, 2006 was approximately $30.9 million and $22.8 million, respectively. The Company schedules production based on firm customer commitments and forecasted requirements. The Company includes in backlog only those customer orders for which it has accepted purchase orders.

Competition

The markets for automated inspection systems and process systems are highly competitive. Important competitive factors include price, performance, reliability, and customer support and service. The Company believes

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that it currently competes effectively with respect to these factors, although there can be no assurance that existing or future competitors will not introduce comparable or superior products at lower prices. Certain of the Company's competitors may have substantially greater financial, technical, marketing and other resources. The Company's principal competitors are believed to be FMC Technologies, Inc., Heat & Control, Inc. and its subsidiaries, BEST N.V., Sortex Ltd. and Kiremko B.V. The Company has encountered additional small competitors entering its markets, including the introduction of potentially competing tobacco sorters into the Chinese market manufactured by Chinese companies. As the Company enters new markets, it expects to encounter additional new competitors.

Patents and Trademarks

The Company currently holds forty-eight United States patents issued from 1989 through 2007, and eleven other national patents issued by other countries. The first of these patents expires in calendar 2008, and the Company believes that expiration will not have a significant effect on the Company. As of December 7, 2007, nineteen other national patent applications have been filed and are pending in the United States and other countries and two international or regional applications have been filed that are awaiting the national phase. The Company has thirty-three registered trademarks and eight pending applications for trademarks.

The Company also attempts to protect its trade secrets and other proprietary information through proprietary information agreements and security measures with employees, consultants and others. The laws of certain countries in which the Company's products are or may be manufactured or sold may not protect the Company's products and intellectual property rights to the same extent as the laws of the United States.

Employees

At September 30, 2007, the Company had 532 full-time employees, including 263 in manufacturing, 79 in engineering, research and development, 135 in marketing, sales and service, and 55 in general administration and finance. A total of 143 employees are located outside the United States. The Company utilizes temporary contract employees, which improves the Company's ability to adjust manpower in response to changing demand for Company products. Of the total employees at September 30, 2007, twenty-six were contract employees. None of the Company's employees in the United States are represented by a labor union. The manufacturing employees located at the Company's facility in Beusichem, The Netherlands are represented by the Small Metal Union. The Company has never experienced a work stoppage, slowdown or strike.

Available Information

The Company's annual and quarterly reports and other filings with the United States Securities and Exchange Commission ("SEC") are made available free of charge through the Investor Relations section of the Company's website at www.key.net as soon as reasonably practicable after the Company files such material with the SEC. The information on or that can be accessed through the Company's website is not a part of this Annual Report on Form 10-K.

ITEM 1A. RISK FACTORS.

In addition to the other information in this Annual Report on Form 10-K, the following risk factors should be considered carefully in evaluating the Company and its business because such factors may have a significant effect on its operating results and financial condition. As a result of the risk factors set forth below and the information presented elsewhere in this Annual Report on Form 10-K, actual results could differ materially from those included in any forward-looking statements.

Adverse economic conditions in the food processing industry, either globally or regionally, may adversely affect the Company's revenues.

The markets the Company serves, particularly the food processing industry, are experiencing variable economic conditions. The U.S. and European markets in the food processing industry are not growing and are experiencing

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consolidation. Additionally, varying consumer demand, product supply, and plant capacity, most notably in the potato market, could result in reduced or deferred capital equipment purchases for the Company's product lines. While the Company has reacted to these developments with applications directed to the growing fresh vegetable and fruit industries as well as the pharmaceutical and nutraceutical industries, loss of business, particularly in the potato industry, would have a negative effect on the Company's sales and net earnings.

Competition and advances in technology may adversely affect sales and prices.

The markets for the Company's products are highly competitive. Advances in technology may remove some barriers to market entry, enabling additional competitors to enter the Company's markets. Such additional competition could force the Company to reduce prices to remain competitive, and decrease the Company's profits, having a material adverse affect on the Company's business and financial condition. There can be no assurance that the Company will be able to continue to compete effectively in the future.

The Company's new products may not compete successfully in either existing or new markets.

The future success and growth of the Company is dependent upon its ability to develop, market, and sell products and services in certain food processing markets as well as to introduce new products into other existing and potential markets. There can be no assurance the Company can successfully penetrate these potential markets or expand into new international markets with its current or new products.

The limited availability and possible cost fluctuations of materials used in the Company's products could adversely affect the Company's business.

Certain of the components, subassemblies and materials for the Company's products are obtained from single sources or a limited group of suppliers. Although the Company seeks to reduce dependence on sole or limited source suppliers, the partial or complete loss of certain of these sources could have an adverse effect on the Company's results of operations and customer relationships. In addition, certain basic materials, such as stainless steel, are used extensively in the Company's product fabrication processes. Such basic materials may also be subject to worldwide shortages or price fluctuations related to the supply of or demand for raw materials, such as nickel, which are used in their production by the Company's suppliers. A significant increase in the price or decrease in the availability of one or more of these components, subassemblies or basic materials could also adversely affect the Company's results of operations. The high price of stainless steel worldwide in fiscal 2006 and 2007 resulted in higher component costs and reduced margins on certain product lines.

The inability to protect its intellectual property, especially as the Company expands geographically, may adversely affect the Company's competitive advantage.

The Company's competitive position may be affected by its ability to protect its proprietary technology. The Company has obtained certain patents and has filed a number of patent applications. The Company also anticipates filing applications for protection of its future products and technology. There can be no assurance that any such patents will provide meaningful protection for the Company's product innovations, or that the issuance of a patent will give the Company any material advantage over its competition in connection with any of its products. The Company may experience additional intellectual property risks in international markets where it may lack patent protection. The patent laws of other countries, such as China, may differ from those of the U.S. as to the patentability of the Company's products and processes. Moreover, the degree of protection afforded by foreign patents may be different from that of U.S. patents.

Intellectual property-related litigation expenses and other costs resulting from infringement claims asserted against the Company by third parties may adversely affect the Company's results of operations and its customer relations.

The technologies used by the Company may infringe the patents or proprietary technology of others. In the past, the Company has been required to initiate litigation to protect its patents. The cost of enforcing the Company's patent rights in lawsuits that it may bring against infringers or of defending itself against infringement charges by

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other patent holders or other third parties, including customers, may be high and could have an adverse effect on the Company's results of operations and its customer relations.

ITEM 2. PROPERTIES.

The Company owns or leases the following properties:

Location	Purpose	Square Feet	Owned or Leased	Lease Expires	Renewal Period
Walla Walla, Washington	Corporate office, manufacturing, research and development, sales and marketing, administration	173,000	Leased with option to purchase within the lease term	2020	None
Redmond, Oregon	Manufacturing, research and development, sales, administration	19,000	Leased	2012	2017
Beusichem, The Netherlands	Manufacturing, sales and marketing, administration	45,000	Leased	2008	2013
Beusichem, The Netherlands	Parts warehouse, future manufacturing expansion	18,000	Owned	n/a	n/a

The Company also has leased office space for sales and service and other activities in Medford, Oregon, Dingley, Australia, Shanghai, China, Santiago de Querétaro, Mexico and Rotselaar, Belgium.

The Company considers all of its properties suitable for the purposes for which they are used.

ITEM 3. LEGAL PROCEEDINGS.

From time-to-time, the Company is named as a defendant in legal proceedings arising out of the normal course of its business. As of December 7, 2007, the Company was not a party to any material legal proceedings.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

None.

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PART II

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

Common Stock

Shares of the Company's common stock are quoted on the Nasdaq Global Market under the symbol "KTEC". The following table shows the high and low bid prices per share of the Company's common stock by quarter for the two most recent fiscal years ending with the month of July 2006 and shows the high and low sales prices per share of the Company's common stock for August 2006 - September 30, 2007:

Stock price by quarter	High	Low
Fiscal year ended September 30, 2007		
First Quarter	$ 15.230	$ 11.311
Second Quarter	16.870	13.500
Third Quarter	23.100	15.190
Fourth Quarter	30.950	21.170
Fiscal year ended September 30, 2006		
First Quarter	$ 15.000	$ 12.250
Second Quarter	13.175	11.180
Third Quarter	12.860	11.500
Fourth Quarter (July)	13.400	12.050
Fourth Quarter (August – September)	13.330	10.700

The source of these quotations for the Company's common stock was the Nasdaq Online℠ Internet site.

The Company had approximately 1,570 beneficial owners of its common stock, of which 201 are of record, as of December 7, 2007.

The Company has not historically paid dividends on its common or preferred stock. The Board of Directors presently intends to continue its policy of retaining earnings for reinvestment in the operations of the Company. The current credit facility with the Company's principal domestic bank restricts the payment of dividends.

Issuer Purchases of Equity Securities

The following table provides information about purchases made by or on behalf of the Company during the quarter ended September 30, 2007 of equity securities registered by the Company under Section 12 of the Securities Exchange Act of 1934.

Period	Stock Repurchase Program (1) Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs

		Programs	
July 1 - 31, 2007	0	0	
August 1 - 31, 2007	0	0	
September 1 - 30, 2007	0	0	
Total	0	0	411,748

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(1) The Company initiated a stock repurchase program effective November 27, 2006. The Company may purchase up to 500,000 shares of its own common stock under the program.

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STOCK PERFORMANCE GRAPH

COMPARISON OF FIVE-YEAR CUMULATIVE TOTAL RETURN
AMONG KEY TECHNOLOGY, INC., A PEER GROUP, AND THE RUSSELL MICROCAP INDEX

TOTAL RETURN ANALYSIS

	9/30/2002	9/30/2003	9/30/2004	9/30/2005	9/30/2006	9/30/2007
Key Technology	**$ 100.00**	**$ 236.91**	**$ 224.55**	**$ 283.43**	**$ 255.09**	**$ 600.80**
Peer Group	**$ 100.00**	**$ 148.70**	**$ 228.49**	**$ 262.75**	**$ 286.21**	**$ 512.40**
Russell Microcap	**$ 100.00**	**$ 154.27**	**$ 177.18**	**$ 207.28**	**$ 221.83**	**$ 243.31**

PEER GROUP: Cognex Corp., Perceptron, Inc., Flir Systems, Inc., Flow International Corp., Elbit Vision Systems Ltd., PPT Vision, Inc., Robotic Vision Systems, Inc., FMC Technologies, Inc.

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ITEM 6. SELECTED FINANCIAL DATA.

The selected consolidated financial information set forth below for each of the five years in the period ended September 30, 2007 has been derived from the audited consolidated financial statements of the Company. The information below should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the Company's Consolidated Financial Statements and Notes thereto as provided in Item 7 and Item 8 of this Annual Report on Form 10-K, respectively.

	Fiscal Year Ended September 30,				
	2007	2006	2005	2004	2003
	(in thousands, except per share data)				
Statement of Operations Data:					
Net sales	$ 107,540	$ 84,840	$ 80,322	$ 80,610	$ 82,622
Cost of sales	66,099	53,041	49,145	46,887	48,626
Gross profit	41,441	31,799	31,177	33,723	33,996
Operating expenses	32,839	31,743	27,193	28,295	25,221
Gain on sale of assets	23	109	28	5	4
Income from operations	8,625	165	4,012	5,433	8,779
Other income (expense)	1,961	(980)	(419)	(132)	(327)
Earnings (loss) from continuing operations before income taxes	10,586	(815)	3,593	5,301	8,452
Income tax (benefit) expense	3,176	(22)	902	1,617	2,693
Net earnings	7,410	(793)	2,691	3,684	5,759
Assumed dividends on mandatorily redeemable preferred stock	--	--	(33)	(69)	(132)
Accretion of mandatorily redeemable preferred stock	--	--	--	--	--
Net earnings (loss) available to common shareholders	$ 7,410	$ (793)	$ 2,658	$ 3,615	$ 5,627
Earnings (loss) per share – basic	$ 1.41	$ (0.15)	$ 0.53	$ 0.74	$ 1.18
– diluted	$ 1.37	$ (0.15)	$ 0.52	$ 0.71	$ 1.15
Cash dividends per share	$ --	$ --	$ --	$ --	$ --
Shares used in per share calculation – basic	5,265	5,205	5,041	4,909	4,774
– diluted	5,407	5,205	5,219	5,222	4,989
Balance Sheet Data:					
Cash and cash equivalents and short-term investments	$ 27,880	$ 15,246	$ 13,181	$ 8,817	$ 6,442
Working capital	40,946	30,057	28,164	20,991	17,226
Property, plant and equipment, net.	4,671	4,275	4,264	5,046	5,503
Total assets	75,497	57,938	57,527	52,514	51,215
Current portion of long-term debt	--	1	1,121	1,210	1,066
Long-term debt, less current portion	--	--	1,199	2,323	3,249
	--	--	--	1,595	1,882

Mandatorily redeemable preferred stock and warrants, including current portion					
Shareholders' equity	50,393	41,252	40,471	36,044	30,219

Certain reclassifications have been made to prior year amounts to conform to the current year presentation.

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

Introduction

The Company and its wholly-owned subsidiaries design, manufacture and sell process automation systems, integrating electro-optical inspection, sorting and process systems.

The Company consists of Key Technology, Inc. which directly owns five subsidiaries: Key Holdings USA LLC; Key Technology Australia Pty Ltd.; Productos Key Mexicana S. de R. L. de C.V.; Key Technology (Shanghai) Trading Co., Ltd.; and Key Technology AMVC LLC (inactive). Key Holdings USA LLC owns Suplusco Holdings B.V., its European subsidiary, which owns Key Technology B.V. Key Technology Australia Pty Ltd. owns Freshline Machines Pty Ltd. (inactive). The Company manufactures products in Walla Walla, Washington; Redmond, Oregon; and Beusichem, The Netherlands.

Overview

Sales for the year ended September 30, 2007 were $107.5 million compared with $84.8 million for fiscal 2006. The Company reported net earnings for fiscal 2007 of $7.4 million, or $1.37 per diluted share, compared with a net loss of $793,000, or $0.15 per diluted share, for fiscal 2006. The principal reasons for the increase in net earnings for fiscal 2007 compared to fiscal 2006 were the 26.8% increase in sales volume, reflecting the 27.4% increase in orders for fiscal 2007, and the improvement of gross margins to 38.5% in fiscal 2007 from 37.5% in fiscal 2006. Automated inspection systems sales were up 55%, process systems sales were up 17%, and parts and service sales remained on par with the prior fiscal year. The primary market forces driving demand for our products are: the increased concerns about food safety and security, the inability of food and pharmaceutical processors to obtain cost effective labor, and the Company's expansion into international markets. Export and international sales for the fiscal years ended September 30, 2007, 2006 and 2005 accounted for 46%, 51% and 52% of net sales in each year, respectively.

In 2007, the Company again focused efforts on three major initiatives to achieve its long-term revenue growth plan:

- Expand and grow its participation in the pharmaceutical and nutraceutical market;
- Strengthen and grow the level of business in China; and
- Continue to grow the Company's aftermarket product lines.

Although the results from 2007 reflected some revenue progress from these initiatives, sales in our core businesses including upgrades accounted for the majority of the increased revenues. The pharmaceutical initiative began in the fourth quarter of 2005 with the formation of the SYMETIX™ business unit. This business unit was formed to dedicate a team of employees to develop and grow Key's business in the pharmaceutical and nutraceutical market. Anticipated penetration into this market will extend and advance the Company's existing patented, high-resolution inspection technology and material handling platforms. Revenue increased $1.4 million in fiscal 2007 to $2.1 million as efforts on the pharmaceutical initiative began to make progress.

The Company has historically been successful in selling tobacco sorters in China. Larger opportunities exist there in the food processing business as well, and the Company invested in China during fiscal 2006 to enhance sales, service and applications support to build upon its established base. In 2006, the Company opened offices and located personnel in-country. In 2007, the Company experienced similar sales volumes into the Chinese market as in 2006, but with new traction in the food processing equipment market which was offset by lower fiscal 2007 tobacco volume. Increased order volume in the last two quarters of fiscal 2007 indicates that the Company's expansion efforts into the Chinese food processing market is gaining traction.

The Company also focused on its aftermarket product lines (which include parts/service and upgrades) during 2007. With the introduction of the G6 family of products in 2005, this enhanced vision engine technology provided additional product upgrade opportunities. Upgrades are an important aspect of the aftermarket product lines, and the

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new modular G6 product family, which provides advanced image processing capability, has been well received by the Company's current customers. Aftermarket sales (including upgrades which are classified in automated inspection systems) increased in fiscal 2007 from fiscal 2006 by 24% to $32.7 million. The Company believes a 42% increase in upgrade orders in fiscal 2007 over fiscal 2006 and the strong backlog at the end of fiscal 2007 bode well for the fiscal 2008 performance of the aftermarket business.

Other accomplishments during fiscal 2007 included completing the initial audit of the Company's internal controls pursuant to Sarbanes-Oxley Section 404, completing the closure of the Company's manufacturing facilities in Australia, reducing staff in the Medford, Oregon sales and engineering office, and selling the Company's interest in the InspX joint venture.

The Company's strategic initiatives for 2008 are to continue to build upon the direction and solid revenue base the Company developed during 2007. The focus for the coming year is to continue to grow sales in the Company's core markets and invest in a market driven technology road map that provides the new products required by our customers. In addition, the Company will focus on four primary industries: potatoes, fresh cut produce, processed fruit and vegetables, and pharmaceutical/nutraceutical, and focus on four developing regions: China, Latin America, Eastern Europe and the Middle East.

The Company also plans to increase research and development expenditures and develop a global Enterprise Resource Planning, or ERP, system. Efforts in research and development will continue to focus on customer solutions, providing new products that meet current needs as well as anticipated future functionality requirements. The Company began preliminary work on developing a global ERP system in the third and fourth quarters of fiscal 2007. The Company has selected an ERP system and a business partner. Implementation will be spread over a three-year period, with total costs of $5.5 million expected over the 2008-2010 period. A significant portion of these ERP implementation costs will be capitalized.

Application of Critical Accounting Policies

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

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

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

Revenue Recognition. The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been provided, the sale price is fixed or determinable, and collectibility is reasonably assured. Additionally, the Company sells its goods on terms which transfer title and risk of loss at a specified location, typically shipping point, port of loading or port of discharge, depending on the final destination of the goods. Accordingly, revenue recognition from product sales occurs when all criteria are met, including transfer of

title and risk of loss, which occurs either upon shipment by the Company or upon receipt by customers at the location specified in the terms of sale. Revenue earned from services (maintenance, installation support, and repairs) is recognized ratably over the contractual period or as the services are performed. If any contract provides for both equipment and services (multiple deliverables), the sales price is allocated to the various elements based on objective evidence of fair value. Each element is then evaluated for revenue recognition based on the previously described

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criteria. The Company's sales arrangements provide for no other significant post-shipment obligations. If all conditions of revenue recognition are not met, the Company defers revenue recognition. In the event of revenue deferral, the sale value is not recorded as revenue to the Company, accounts receivable are reduced by any amounts owed by the customer, and the cost of the goods or services deferred is carried in inventory. In addition, the Company periodically evaluates whether an allowance for sales returns is necessary. Historically, the Company has experienced few sales returns. If the Company believes there are potential sales returns, the Company will provide any necessary provision against sales. In accordance with the Financial Accounting Standard Board's Emerging Issues Task Force Issue No. 01-9, *"Accounting for Consideration Given by a Vendor to a Customer or a Reseller of the Vendor's Product,"* the Company accounts for cash consideration (such as sales incentives) that are given to customers or resellers as a reduction of revenue rather than as an operating expense unless an identified benefit is received for which fair value can be reasonably estimated. The Company believes that revenue recognition is a "critical accounting estimate" because the Company's terms of sale vary significantly, and management exercises judgment in determining whether to recognize or defer revenue based on those terms. Such judgments may materially affect net sales for any period. Management exercises judgment within the parameters of accounting principles generally accepted in the United States of America (GAAP) in determining when contractual obligations are met, title and risk of loss are transferred, the sales price is fixed or determinable and collectibility is reasonably assured. At September 30, 2007, the Company had invoiced $2.3 million compared to $1.5 million at September 30, 2006 for which the Company has not recognized revenue.

Allowances for doubtful accounts. The Company establishes allowances for doubtful accounts for specifically identified, as well as anticipated, doubtful accounts based on credit profiles of customers, current economic trends, contractual terms and conditions, and customers' historical payment patterns. Factors that affect collectibility of receivables include general economic or political factors in certain countries that affect the ability of customers to meet current obligations. The Company actively manages its credit risk by utilizing an independent credit rating and reporting service, by requiring certain percentages of down payments, and by requiring secured forms of payment for customers with uncertain credit profiles or located in certain countries. Forms of secured payment could include irrevocable letters of credit, bank guarantees, third-party leasing arrangements or EX-IM Bank guarantees, each utilizing Uniform Commercial Code filings, or the like, with governmental entities where possible. The Company believes that the accounting estimate related to allowances for doubtful accounts is a "critical accounting estimate" because it requires management judgment in making assumptions relative to customer or general economic factors that are outside the Company's control. As of September 30, 2007, the balance sheet included allowances for doubtful accounts of $414,000. Amounts charged to bad debt expense for fiscal 2007 and 2006 were $16,000 and $29,000, respectively. Actual charges to the allowance for doubtful accounts for fiscal 2007 and 2006 were $98,000 and $83,000, respectively. If the Company experiences actual bad debt expense in excess of estimates, or if estimates are adversely adjusted in future periods, the carrying value of accounts receivable would decrease and charges for bad debts would increase, resulting in decreased net earnings.

Valuation of inventories. Inventories are stated at the lower of cost or market. The Company's inventory includes purchased raw materials, manufactured components, purchased components, work in process, finished goods and demonstration equipment. Write downs for excess and obsolete inventories are made after periodic evaluation of historical sales, current economic trends, forecasted sales, estimated product lifecycles and estimated inventory levels. The factors that contribute to inventory valuation risks are the Company's purchasing practices, electronic component obsolescence, accuracy of sales and production forecasts, introduction of new products, product lifecycles and the associated product support. The Company actively manages its exposure to inventory valuation risks by maintaining low safety stocks and minimum purchase lots, utilizing just in time purchasing practices, managing product end-of-life issues brought on by aging components or new product introductions, and by utilizing inventory minimization strategies such as vendor-managed inventories. The Company believes that the accounting estimate related to valuation of inventories is a "critical accounting estimate" because it is susceptible to changes from period-to-period due to the requirement for management to make estimates relative to each of the underlying factors

ranging from purchasing to sales to production to after-sale support. At September 30, 2007, cumulative inventory adjustments to lower of cost or market totaled $1.8 million compared to $2.2 million as of September 30, 2006. Amounts charged to expense to record inventory at lower of cost or market for fiscal 2007 and 2006 were $386,000 and $1.6 million, respectively. Actual charges to the cumulative inventory adjustments upon disposition or sale of inventory were $903,000 and $2.3 million for fiscal 2007 and 2006, respectively. If actual demand, market conditions or product lifecycles are adversely different from those estimated by management,

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inventory adjustments to lower market values would result in a reduction to the carrying value of inventory, an increase in inventory write-offs, and a decrease to gross margins.

Long-lived assets. The Company regularly reviews all of its long-lived assets, including property, plant and equipment, and amortizable intangible assets, for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. If the total of projected future undiscounted cash flows is less than the carrying amount of these assets, an impairment loss based on the excess of the carrying amount over the fair value of the assets is recorded. In addition, goodwill is reviewed based on its fair value at least annually. As of September 30, 2007, the Company held $10.8 million of property, plant and equipment, goodwill and other intangible assets, net of depreciation and amortization. There were no changes in the Company's long-lived assets that would result in an adjustment of the carrying value for these assets. Estimates of future cash flows arising from the utilization of these long-lived assets and estimated useful lives associated with the assets are critical to the assessment of recoverability and fair values. The Company believes that the accounting estimate related to long-lived assets is a "critical accounting estimate" because: (1) it is susceptible to change from period to period due to the requirement for management to make assumptions about future sales and cost of sales generated throughout the lives of several product lines over extended periods of time; and (2) the potential effect that recognizing an impairment could have on the assets reported on the Company's balance sheet and the potential material adverse effect on reported earnings or loss. Changes in these estimates could result in a determination of asset impairment, which would result in a reduction to the carrying value and a reduction to net earnings in the affected period.

Allowances for warranties. The Company's products are covered by standard warranty plans included in the price of the products ranging from 90 days to five years, depending upon the product and contractual terms of sale. The majority of product warranties are for periods between one and two years. The Company establishes allowances for warranties for specifically identified, as well as anticipated, warranty claims based on contractual terms, product conditions and actual warranty experience by product line. Company products include both manufactured and purchased components and, therefore, warranty plans include third-party sourced parts which may not be covered by the third-party manufacturer's warranty. Ultimately, the warranty experience of the Company is directly attributable to the quality of its products. The Company actively manages its quality program by using a structured product introduction plan, process monitoring techniques utilizing statistical process controls, vendor quality metrics, a quality training curriculum for every employee and feedback loops to communicate warranty claims to designers and engineers for remediation in future production. The Company believes that the accounting estimate related to allowances for warranties is a "critical accounting estimate" because: (1) it is susceptible to significant fluctuation period to period due to the requirement for management to make assumptions about future warranty claims relative to potential unknown issues arising in both existing and new products, which assumptions are derived from historical trends of known or resolved issues; and (2) risks associated with third-party supplied components being manufactured using processes that the Company does not control. As of September 30, 2007, the balance sheet included warranty reserves of $1.4 million, while $2.1 million of warranty charges were incurred during the fiscal year then ended, compared to warranty reserves of $1.0 million as of September 30, 2006 and warranty charges of $2.0 million for the fiscal year then ended. If the Company's actual warranty costs are higher than estimates, future warranty plan coverages are different, or estimates are adversely adjusted in future periods, reserves for warranty expense would need to increase, warranty expense would increase and gross margins would decrease.

Accounting for income taxes. The Company's provision for income taxes and the determination of the resulting deferred tax assets and liabilities involves a significant amount of management judgment. The quarterly provision for income taxes is based partially upon estimates of pre-tax financial accounting income for the full year and is affected by various differences between financial accounting income and taxable income. Judgment is also applied in determining whether the deferred tax assets will be realized in full or in part. In management's judgment, when it is more likely than not that all or some portion of specific deferred tax assets, such as foreign tax credit carryovers, will not be realized, a valuation allowance must be established for the amount of the deferred tax assets that are determined

not to be realizable. At September 30, 2007, the Company had valuation reserves of approximately $510,000 consisting of $450,000 for deferred tax assets related to the sale of the investment in the InspX joint venture and the valuation reserve for notes receivable and contingent payments; and a net $60,000 for combined U.S., Australian and Chinese deferred tax assets and liabilities, primarily related to net operating loss carryforwards in those foreign jurisdictions. There were no other valuation allowances at September 30, 2007 due to anticipated utilization of all the deferred tax assets as the Company believes it will have sufficient taxable income to utilize these

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assets. The Company maintains reserves for estimated tax exposures in jurisdictions of operation. These tax jurisdictions include federal, state and various international tax jurisdictions. Potential income tax exposures include potential challenges of various tax credits, export-related tax benefits, and issues specific to state and local tax jurisdictions. Exposures are typically settled primarily through audits within these tax jurisdictions, but can also be affected by changes in applicable tax law or other factors, which could cause management of the Company to believe a revision of past estimates is appropriate. During fiscal 2007 and 2006, there have been no significant changes in these estimates. Management believes that an appropriate liability has been established for estimated exposures; however, actual results may differ materially from these estimates. The Company believes that the accounting estimate related to income taxes is a "critical accounting estimate" because it relies on significant management judgment in making assumptions relative to temporary and permanent timing differences of tax effects, estimates of future earnings, prospective application of changing tax laws in multiple jurisdictions, and the resulting ability to utilize tax assets at those future dates. If the Company's operating results were to fall short of expectations, thereby affecting the likelihood of realizing the deferred tax assets, judgment would have to be applied to determine the amount of the valuation allowance required to be included in the financial statements in any given period. Establishing or increasing a valuation allowance would reduce the carrying value of the deferred tax asset, increase tax expense and reduce net earnings.

In October 2004, the American Jobs Creation Act of 2004 was enacted. This legislation phases out the Extra Territorial Income Exclusion ("ETI") beginning January 1, 2005 through December 31, 2006. The ETI exclusion reduced the Company's effective tax rate by 0.2%, 14.3% and 5.4% in 2007, 2006 and 2005, respectively. The legislation also provides for a new deduction for manufacturing income, which phases in beginning in the Company's 2006 fiscal year through 2010. The Company anticipates that this deduction will largely, if not completely, offset the loss of the ETI exclusion. However, the effects in individual fiscal years during the phase-in periods may vary and increase the Company's effective tax rate during these periods. For fiscal 2007 and 2006, the deduction for manufacturing income reduced the Company's effective tax rate by 0.8% and 0%, respectively.

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Summary of Financial Information

	Fiscal Year Ended September 30,			
	2007	2006	Change $	Change %
	(in thousands)			
Statement of Operations Data				
Net sales	$ 107,540	$ 84,840	$ 22,700	26.8
Gross profit	41,441	31,799	9,642	30.3
Research and development	5,520	6,444	(924)	-14.3
Sales and marketing	17,191	14,784	2,407	16.3
General and administrative	8,821	9,185	(364)	-4.0
Amortization	1,307	1,330	(23)	-1.7
Total operating expense	32,839	31,743	1,096	3.5
Gain on sale of assets	23	109	(86)	N/M*
Income from operations	8,625	165	8,460	N/M*
Other income and expense	1,961	(980)	2,941	N/M*
Income tax expense (benefit)	3,176	(22)	3,198	N/M*
Net income (loss)	7,410	(793)	8,203	N/M*
Balance Sheet Data				
Cash and cash equivalents	27,880	15,246	12,634	82.9
Accounts receivable	14,020	10,381	3,639	35.1
Inventories	18,753	16,035	2,718	17.0
Other Data *(unaudited)*				
Orders	115,276	90,500	24,776	27.4
Backlog	30,931	22,756	8,175	35.9

** Not meaningful*

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Results of Operations

Fiscal 2007 compared to Fiscal 2006

Net sales for the year ended September 30, 2007 were $107.5 million, a 27% increase over the $84.8 million reported for fiscal 2006. The Company ended the year strongly with a record fourth quarter of $31.7 million in sales, a 31% increase over the corresponding period in fiscal 2006.

Sales in the Company's automated inspection systems product line increased by 55% to $46.9 million in fiscal 2007, accounting for 44% of total revenues, compared to $30.3 million in fiscal 2006 and 36% of total revenues. The most significant increase was in upgrade sales which increased $5.7 million or 81% to $12.7 million. Sales increased in all automated inspection product lines except tobacco, which dropped $2.5 million to $0.7 million in fiscal 2007 as a result of a significant tobacco order from China that shipped in fiscal 2006. Process systems sales in fiscal 2007 were $40.9 million, a 17.2% increase over the $34.9 million reported for fiscal 2006. Sales of process systems accounted for 38% of total revenues in fiscal 2007 compared to 41% in fiscal 2006. Shipments of process systems in fiscal 2007 from United States operating locations increased nearly 27% and from the Netherlands increased by nearly 12%. Parts and service sales remained on par with the prior year at $19.7 million and represented 18% of sales this year, down from 23% of sales in fiscal 2006.

New orders increased 27%, or $24.8 million, to $115.3 million in fiscal 2007 over the $90.5 million in orders received in fiscal 2006. Backlog at September 30, 2007 increased to $30.9 million compared to the $22.8 million reported at the end of fiscal 2006. The order mix for the more recent year improved over fiscal 2006. The Company's higher margin automated inspection systems orders increased to almost 42% of order volume in fiscal 2007 compared to 40% in the prior year due in large part to an almost 42% increase in upgrade orders and a $3.0 million increase in SYMETIX orders.

Gross profits increased to $41.4 million for fiscal 2007 compared to $31.8 million in fiscal 2006, or 38.5% and 37.5% of sales, respectively. The principle driver for the $9.6 million increase in gross profit relates to the nearly 27% increase is sales volume. The improvement in gross profit percentage relates to the increased mix of automated inspection systems sales as well as lower other cost of sales relating to improved manufacturing and overhead variances. Gross profits were negatively affected by higher raw material cost increases driven by stainless steel pricing, as well as lower labor efficiencies relating to hiring and training over 40 new production employees in 2007.

Research and development spending decreased $924,000 to $5.5 million, or 5.1% of sales, in fiscal 2007 from $6.4 million and 7.6% of sales in fiscal 2006. The decrease was driven largely by focusing on fewer research and development projects, as well as the closure and the reduction in staffing of the Company's Medford, Oregon facility.

Sales and marketing spending in fiscal 2007 was $17.2 million, a significant increase from the $14.8 million spent in fiscal 2006. As a percent of sales, costs dropped 1.4% from the 17.4% of sales reported in fiscal 2006 to 16.0% of sales reported in fiscal 2007. The primary drivers for the increase were the significantly higher sales volume, as well as continued investment in the Company's China sales office and its SYMETIX initiative in the pharmaceutical and nutraceutical industry.

General and administrative spending in fiscal 2007 was $8.8 million and 8.2% of sales for the year, compared to $9.2 million and 10.8% of sales for fiscal 2006. The decrease in fiscal 2007 was due to the closure of the Company's operations in Australia and reduced management consulting costs. General and administrative costs incurred in 2006 included non-recurring costs related to information system upgrades. General and administrative costs decreased in fiscal 2007 despite the $500,000 of external costs incurred to comply with Section 404 of the Sarbanes-Oxley Act.

Other income and expense was $2 million of income for fiscal 2007 compared to $1 million of expense for fiscal 2006. During fiscal 2007, the Company recognized a gain of $750,000 from the sale of the investment in the InspX joint venture. In fiscal 2006, the Company booked a charge of $865,000 related to the write-off of it's investment in InspX. During fiscal 2006, the Company's equity in the earnings of InspX was an additional loss of $389,000.

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Interest income increased to $726,000 in fiscal 2007 from the $391,000 reported for fiscal 2006 due to increased investment of cash generated by operations. The Company also recognized exchange gains of $570,000 in fiscal 2007 compared with $86,000 in the prior year.

The effective tax rate for the Company was 30.2% in fiscal 2007 compared to 2.7% in fiscal 2006. The effective tax rate for fiscal 2007 was primarily affected by the reversal of valuation reserves recorded in fiscal 2006 related to the Company's valuation of its investment in the InspX joint venture. Other items, such as permanent differences arising from extra-territorial income exclusions, domestic production deductions, research and development tax credits, tax exempt interest, and other permanent differences, caused the effective tax rate to vary from the 34% statutory rate in fiscal 2007.

Net earnings in fiscal 2007 were $7.4 million, or $1.37 per diluted share, compared to a net loss of $793,000, or $0.15 per diluted share, in fiscal 2006. The principal reasons for the increase in earnings for fiscal 2007 compared to fiscal 2006 were increased sales volumes and improved gross profit margins. In addition, earnings improved due to the effect of the InspX transactions in both years.

Fiscal 2006 compared to Fiscal 2005

Net sales for the year ended September 30, 2006 were $84.8 million, a 5.6% increase over the $80.3 million reported for fiscal 2005. The Company ended the year strongly with a record fourth quarter of $24.2 million in sales, a 12.1% increase over the corresponding period in fiscal 2005.

Sales in the Company's automated inspection systems product line increased by 8.6% to $30.3