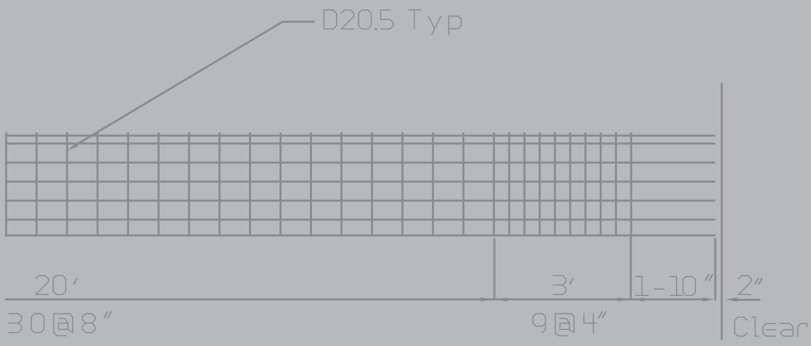
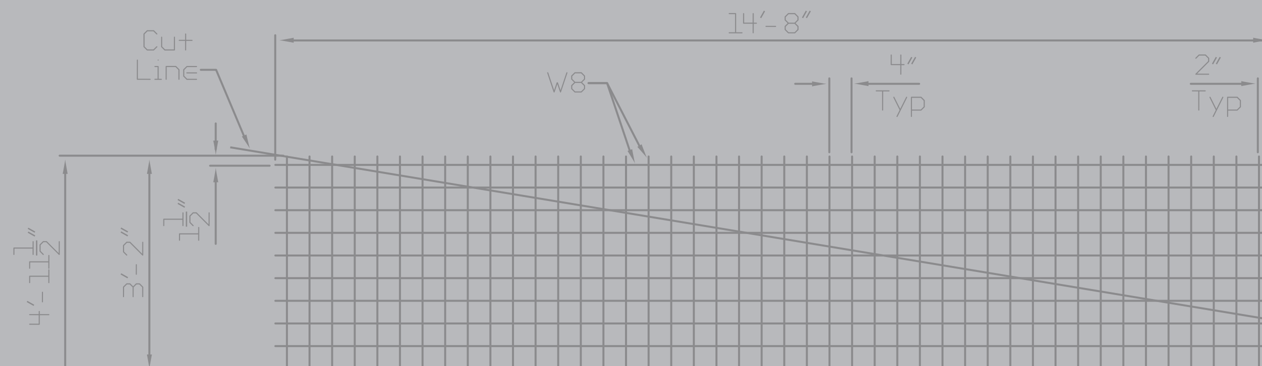
57,1875″
57,875″
Typ B & C
1′-0 13/16″ Typ
ESM Type B
Typ 1′-1″ B & C
2 15/16″ Typ
2″ Typ Clear
ESM Type C
ESM Type A
2 1/16″
24′ ESM Type″B,A,C″
ESM Type D
24′-4 1/8″
9′-8 13/16″
163.65 degrees
65.45 degrees



INSTEEL INDUSTRIES

2006 Annual Report



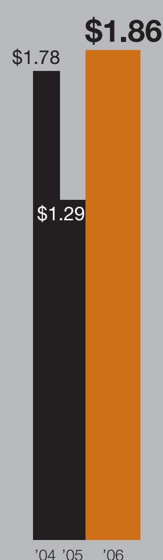
FINANCIAL HIGHLIGHTS

(In thousands, except for per share amounts)	2006	2005	2004
Operating Results:			
Net sales	$329,507	$309,320	$298,754
Gross profit	70,871	57,898	78,956
Selling, general and administrative expense	16,996	16,175	21,194
Interest expense	669	3,427	5,832
Earnings from continuing operations	34,377	24,499	32,035
Net earnings	33,040	25,045	31,489
Per Share Data:			
Basic:			
Earnings from continuing operations	$ 1.88	$ 1.31	$ 1.85
Net earnings	1.80	1.34	1.82
Diluted:			
Earnings from continuing operations	1.86	1.29	1.78
Net earnings	1.79	1.32	1.75
Cash dividends declared	0.12	0.06	—
Financial Position:			
Total assets	$166,596	$138,276	$151,291
Total long-term debt	—	11,860	52,928
Shareholders' equity	122,438	97,036	71,211
Cash Flows:			
Net cash provided by operating activities of continuing operations	$ 42,650	$ 41,830	$ 29,929
Capital expenditures	18,959	6,302	2,921
Depreciation and amortization	5,107	5,627	6,209
Repurchase of common stock	8,529	—	—
Cash dividends paid	2,222	566	—

Business Overview >

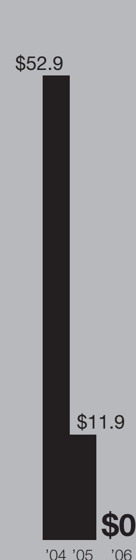
Net Sales
(in millions)

Diluted Earnings Per Share From Continuing Operations



Cash From Operating Activities of Continuing Operations
(in millions)

Total Long-Term Debt
(in millions)



INSTEEL INDUSTRIES—BUSINESS OVERVIEW

Insteel Industries is one of the nation's largest manufacturers of steel wire reinforcing products for concrete construction applications. We manufacture and market prestressed concrete strand ("PC strand") and welded wire reinforcement, including concrete pipe reinforcement, engineered structural mesh and standard welded wire reinforcement. Our products are sold primarily to manufacturers of concrete products that are used in nonresidential construction. Headquartered in Mount Airy, North Carolina, we operate six manufacturing facilities located in the United States.

WELDED WIRE REINFORCEMENT

Prefabricated reinforcement consisting of high-strength, cold-drawn or cold-rolled longitudinal and transverse wires welded together in square or rectangular grids according to customer requirements. Wire intersections are electrically resistance-welded by a computer-controlled continuous automatic welder which uses pressure and heat to fuse all wires in their proper position, creating a consistent high quality reinforcing product.

Concrete Pipe Reinforcement

Engineered made-to-order product that is used as the primary reinforcement in concrete pipe and box culverts for drainage and sewage systems, water treatment facilities and other related applications.

PLANT LOCATIONS: Dayton, Texas; Mount Airy, North Carolina; Wilmington, Delaware

CUSTOMER SEGMENTS: Concrete pipe and precast producers

END USES: Nonresidential and residential construction

Engineered Structural Mesh

Engineered made-to-order product that is used as the primary reinforcement in concrete elements or structures, frequently serving as a replacement for hot-rolled rebar.

PLANT LOCATIONS: Dayton, Texas; Mount Airy, North Carolina

CUSTOMER SEGMENTS: Precast and prestressed producers, rebar fabricators, distributors

END USES: Nonresidential construction

Standard Welded Wire Reinforcement

Secondary reinforcing product that is produced in standard styles for crack control applications in residential and light nonresidential construction, including driveways, sidewalks and a wide range of slab-on-grade applications.

PLANT LOCATIONS: Dayton, Texas; Hickman, Kentucky; Mount Airy, North Carolina; Wilmington, Delaware

CUSTOMER SEGMENTS: Rebar fabricators and distributors

END USES: Nonresidential and residential construction

PRESTRESSED CONCRETE STRAND

High strength seven-wire reinforcement consisting of six cold-drawn wires that are continuously wrapped around a center wire forming a strand. The strand is heat-treated while under tension, which imparts low relaxation characteristics and increases the working range of the product, providing engineers with greater flexibility in its application and the ability to better utilize its reinforcing properties. PC strand is used to impart compression forces into prestressed concrete elements and structures, which may be either pretensioned or posttensioned. Pretensioned means that the strands are tensioned to their design load and anchored at the ends of a form. After the concrete has been placed and allowed to cure to sufficient strength, the load on the strand is transferred from the external anchors to the cured member, creating compression forces within the element, or "prestressing" it. Posttensioned means that the strands are tensioned after the concrete has been placed and allowed to cure.

PLANT LOCATIONS: Gallatin, Tennessee; Sanderson, Florida

CUSTOMER SEGMENTS: Precast prestress producers, posttension suppliers

END USES: Nonresidential and residential construction

COVER: *Engineering drawings for some of Insteel's welded wire reinforcement products.*

2006 NET SALES BY PRODUCT LINE

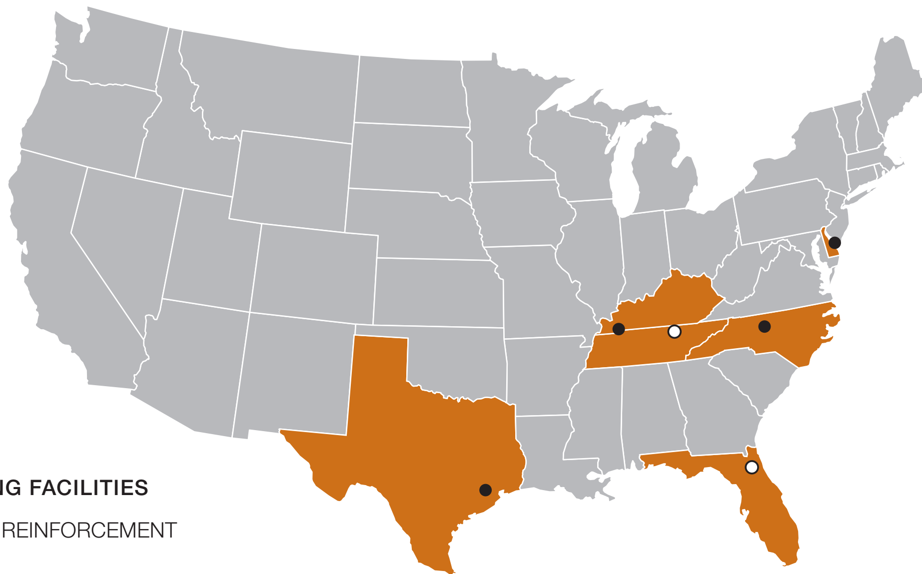
54% WELDED WIRE REINFORCEMENT
46% PC STRAND

2006 NET SALES BY END USE

80% NONRESIDENTIAL CONSTRUCTION
20% RESIDENTIAL CONSTRUCTION

2006 NET SALES BY CUSTOMER CHANNEL

76% CONCRETE PRODUCT MANUFACTURERS
13% DISTRIBUTORS
11% REBAR FABRICATORS

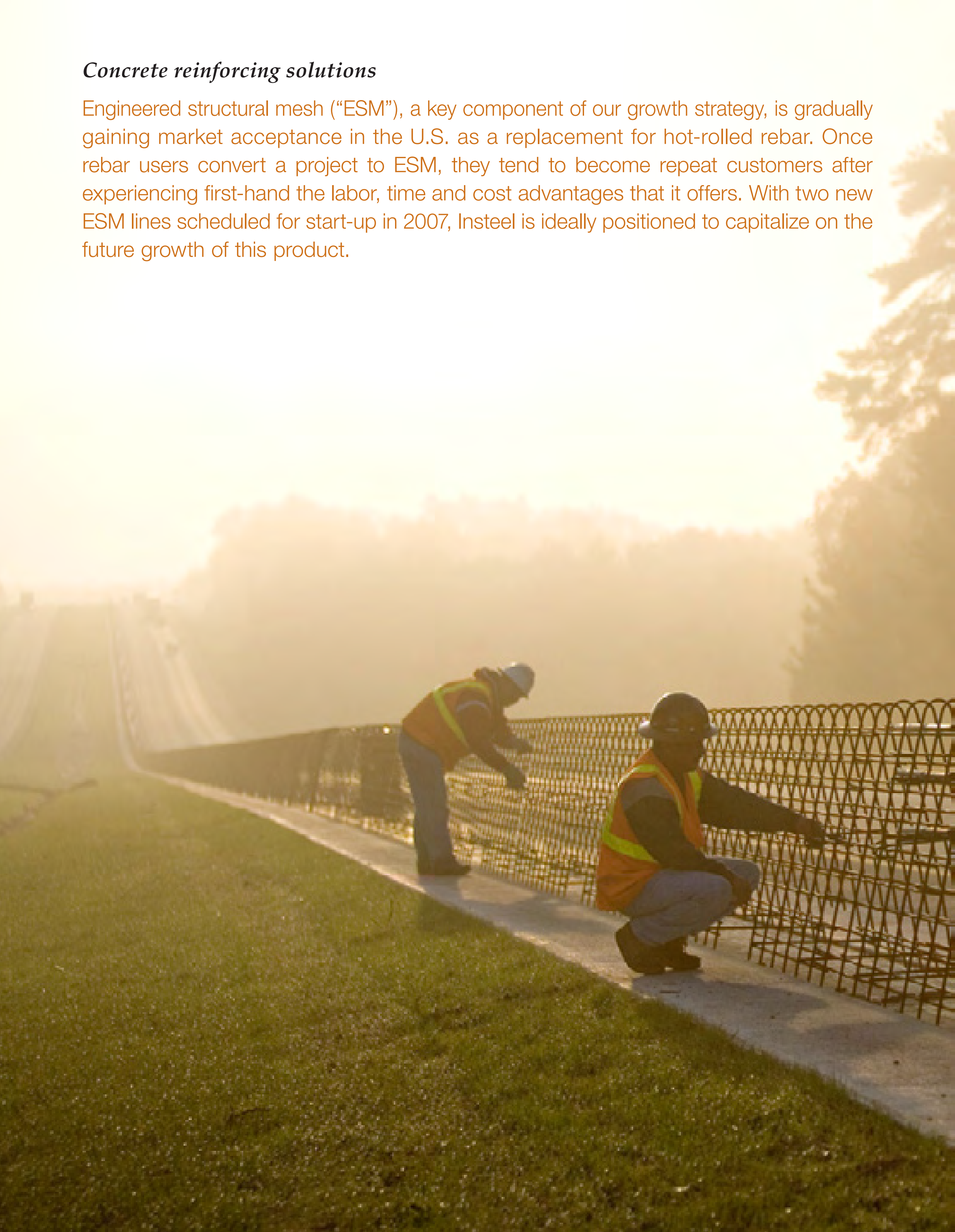


MANUFACTURING FACILITIES

● WELDED WIRE REINFORCEMENT

○ PC STRAND

Over 30% of the bridges in this country are estimated to be either structurally deficient or functionally obsolete. The ongoing replacement of these structures together with the construction of new bridges to alleviate the growing congestion on our roadways should be significant sources of demand for Insteel's concrete reinforcing products.



Concrete reinforcing solutions

Engineered structural mesh ("ESM"), a key component of our growth strategy, is gradually gaining market acceptance in the U.S. as a replacement for hot-rolled rebar. Once rebar users convert a project to ESM, they tend to become repeat customers after experiencing first-hand the labor, time and cost advantages that it offers. With two new ESM lines scheduled for start-up in 2007, Insteel is ideally positioned to capitalize on the future growth of this product.

Insteel ESM is placed on the roadway in preparation for the casting of the concrete median barrier on-site. For this particular project, 38.4 tons of ESM were consumed per mile of barrier.

Highways and overpasses are significant consumers of Insteel's concrete reinforcing products. PC strand and welded wire reinforcement ("WWR") are integral to the precast concrete elements that are used in overpass construction, while WWR is used in the concrete pipes and culverts that drain roadways as well as for median barriers, bridge decks and other related applications.

FAVORABLE OUTLOOK FOR DEMAND DRIVERS

Continued growth in nonresidential construction. Increased infrastructure spending at the federal and state level. Post-hurricane reconstruction in the Gulf region.

The overall demand outlook for Insteel continues to be favorable as the growth in nonresidential construction, which drives approximately 80% of our revenues, should more than offset the weakening in the housing sector. Commercial, industrial and institutional construction is expected to remain strong in 2007. Infrastructure construction should benefit from the SAFETEA-LU federal highway funding authorization and improved budgetary positions at the state level. We also anticipate increasing demand from the post-hurricane reconstruction in the Gulf region where many of our customers have been expanding their facilities or adding new locations in anticipation of the upturn in demand. Through our strong market presence, broad offering of concrete reinforcing products, strategically-located manufacturing facilities and internal expansions scheduled to come on-line in 2007, we believe that we are well-positioned to capitalize on the expected growth in demand.

Increasing our market penetration. Expanding our geographic footprint. Creating value-added for our customers and shareholders.

Our existing businesses offer attractive growth opportunities which we are aggressively pursuing internally as well as through acquisitions.

Organic growth. The addition of two new ESM lines together with the reconfiguration and expansion of our PC strand operation in Tennessee will provide additional capacity to support future revenue growth. In addition, the state-of-the-art equipment that we are deploying is expected to yield significant reductions in our unit operating costs.

Acquisitions. Our acquisition focus is on companies in our existing businesses that would further our market penetration or expand our geographic footprint and leverage our infrastructure and core competencies in concrete reinforcing products. With our strong balance sheet and financial flexibility, we are ideally situated to pursue growth opportunities that create value for our shareholders.

These concrete sections were manufactured at a customer's precast operation and reinforced using Insteel PC strand. After being moved by crane to a storage area, they will later be shipped to a construction site.

By any measure, 2006 was a great year for Insteel. We delivered strong financial results for our shareholders while making strategic investments for the future that will improve our cost competitiveness and expand our revenue generating capacity. Our business strategy remains focused on strengthening our leadership positions in our markets and operating as the lowest cost producer. We believe these factors are prerequisites to gaining competitive advantage and positioning the Company for continued success during future economic downturns.

FINANCIAL HIGHLIGHTS

Sales from continuing operations for 2006 rose 7% to an all-time high of $329.5 million from $309.3 million in 2005 on an 11% increase in shipments which more than offset a 4% reduction in average selling prices. Earnings from continuing operations also reached a new record high, increasing 40% to $34.4 million ($1.86 per diluted share) from $24.5 million ($1.29 per diluted share) in 2005 driven by the higher shipments and wider spreads between average selling prices and raw material costs. Including the results of discontinued operations, net earnings were $33.0 million ($1.79 per diluted share) compared with $25.0 million ($1.32 per diluted share) in 2005.

Conditions in our nonresidential construction markets, which represent approximately 80% of revenues, were strong during 2006 driven by the increased spending for commercial, industrial, institutional and infrastructure construction. In contrast, markets related to housing, representing approximately 20% of revenues, deteriorated over the course of the year, with softening conditions exacerbated by inventory reduction measures pursued by customers in this sector during the fourth quarter. Despite the weakening in housing-related markets during the latter part of the year, margins remained favorable with costs moderating as selling prices declined. The exception to this trend was the commercial segment of our PC strand market where import pricing became increasingly irrational throughout the year. Fortunately, strong demand and the growth of the strand market muted the impact of the import pricing pressures during 2006.

Cash from operating activities of continuing operations improved to $42.7 million in 2006, which was used to fund $19.0 million of capital expenditures, repay the remaining $11.9 million of debt that was outstanding on our credit facility, purchase $8.5 million of stock and pay $2.2 million of dividends to our shareholders. Our year-end balance sheet was debt-free, leaving us well-positioned to pursue further internal growth opportunities and acquisitions.

1. What is the appropriate industry classification for Insteel—building materials or steel?

Following our exit from the industrial wire business, all of our revenues are generated by concrete reinforcing products that are sold primarily to manufacturers of concrete products for construction applications. Based on our current product and customer mix, about 80% of our business is driven by nonresidential construction and 20% by residential construction. Although hot-rolled steel wire rod is our primary raw material, on a historical basis, Insteel's financial results have not been closely correlated with the results for the steel industry as a whole. For these reasons, we believe that Insteel should be classified as a manufacturer of building materials.

EXIT FROM INDUSTRIAL WIRE BUSINESS

In response to weakening market conditions and the expected continuation of reduced operating levels, in June, we exited the industrial wire business with the closure of our Fredericksburg, Virginia facility and in July, disposed of its equipment for $6.0 million. We expect to complete the sale of the related real estate and other remaining assets in early 2007. Our exit from the industrial wire business narrows our strategic and operational focus to concrete reinforcing products where our market positions are strong and the business prospects are more favorable.

GROWTH STRATEGY

Our growth strategy continues to be focused on organic opportunities in existing businesses as well as acquisitions that leverage our infrastructure and core competencies in concrete reinforcing products.

Organic growth. During 2006, substantial progress was made on the expansions of our ESM and PC strand businesses. In addition to providing added capacity to capitalize on the anticipated growth in demand, these projects should significantly reduce our unit operating costs through the state-of-the-art equipment that will be deployed.

Shipments of ESM rose 38% in 2006 from a year ago as we continued to gain market momentum, expanding our sales to existing customers as well as developing new business with users of hot-rolled rebar. Our ESM marketing program has been increasingly effective in conveying the advantages that the product offers relative to rebar. As we are able to effect conversions to ESM and purchasers experience first-hand its inherent labor, cycle time and material cost advantages, repeat orders generally follow. Unlike our other product lines, ESM applications are almost exclusively in the nonresidential construction sector and unaffected by the softening in the housing market. More importantly, the product is still early in its life

QUESTION & ANSWER

2. **What effect do fluctuations in steel prices have on Insteel's financial performance?**

It is not possible to determine how changes in steel prices will affect Insteel's financial results without considering market conditions for its products. During certain periods such as in 2004, rising prices for hot-rolled steel wire rod, our primary raw material, have served as a catalyst for even larger increases in our selling prices, favorably impacting margins. During other periods when market conditions were weak, we have been unable to pass through higher rod costs and suffered margin erosion. Ultimately, it is the supply and demand for our products and competitive dynamics that determine the net impact of increases or decreases in steel prices.

cycle offering attractive growth potential. We estimate that total domestic consumption of ESM represents less than 10% of the potential volume for applications in which it could serve as a substitute for rebar.

We expect to complete the ESM expansion in our North Carolina plant during the second quarter of 2007 followed by the start-up of an additional ESM production line in our Texas plant during the third quarter of 2007. When operating on a full schedule, each line has the potential to generate $16.0 to $20.0 million of revenues annually based on current average selling prices.

The PC strand expansion at our Tennessee plant involves the consolidation of manufacturing processes currently performed in two adjacent facilities into one facility together with the installation of a new production line. Following the anticipated completion of the project in the second quarter, we plan to ramp up the operating volume of the new line expeditiously in order to maximize the anticipated productivity and cost improvements and adjust the utilization levels of existing lines based on market conditions. The Tennessee expansion is expected to increase our PC strand capacity by $25.0 to $30.0 million annually based on current average selling prices.

Acquisitions. In addition to our organic growth initiatives, we are continually evaluating acquisition opportunities that would further our penetration in current markets or expand our geographic footprint. We will adhere to a disciplined approach, pursuing only those opportunities that meet our return on capital criteria and create value for our shareholders.

LOOKING AHEAD

As we look ahead to 2007, we expect to deliver another year of solid financial results. The outlook for our primary market, nonresidential construction, continues to be favorable.

3. Does import competition pose a threat to Insteel?

Following the series of divestitures that were completed since 2001, we have significantly reduced Insteel's sensitivity to import competition. Based on our current product and customer mix, we estimate that 30% of our revenues are subject to import competition. Imports are not a significant factor in our welded wire reinforcement business outside the immediate border areas of the U.S. In PC strand, the government-funded segment, which represents about 25% of the market, is subject to "Buy America" requirements which prohibit the use of foreign-sourced material. However, the commercial segment of the market can be significantly impacted by imports and import pricing can affect the governmental segment as well depending upon comparative market conditions.

Commercial, industrial and institutional construction is expected to remain strong. Infrastructure construction should benefit from the recent enactment of the SAFETEA-LU federal highway funding authorization and improved fiscal positions at the state level. We also anticipate increasing demand from the post-hurricane reconstruction in the Gulf region which has had a minimal impact up to this point.

At the same time, we expect to face significant near-term challenges and margin pressure from weaker housing-related demand, increasing import competition in our PC strand business, and higher cost raw material purchase commitments early in the year which may be difficult to pass through in our markets. As we move into the second half of 2007, we expect that business conditions will improve and support the maintenance of spreads and gross margins at attractive levels. This improvement should be augmented by the gradually increasing contributions from our ESM and PC strand expansions in the form of reduced operating costs and additional volume.

We thank our customers, employees and shareholders for their continued trust, confidence and support as we move into the next exciting chapter of Insteel's history. We are confident that Insteel is well-positioned to capitalize on the opportunities and respond to the challenges that lie ahead. Although we are pleased with our recent performance, we continue to believe that our best years are ahead of us.

Sincerely,

H.O. Woltz III

President and Chief Executive Officer

4. How does Insteel plan to use cash over the next few years?

Our plans for use of cash are to fund our growth through internal expansions and acquisitions, pay dividends and repurchase shares of our stock, as warranted by market conditions. Although we were in a debt-free position as of year-end, we have a $100.0 million revolving credit facility in place to supplement our operating cash flow in funding cash requirements that may arise. Going forward, we are committed to maintaining a capital structure that provides us with the flexibility to pursue future growth opportunities as well as maintain adequate liquidity to withstand economic or cyclical downturns.

FINANCIAL REVIEW

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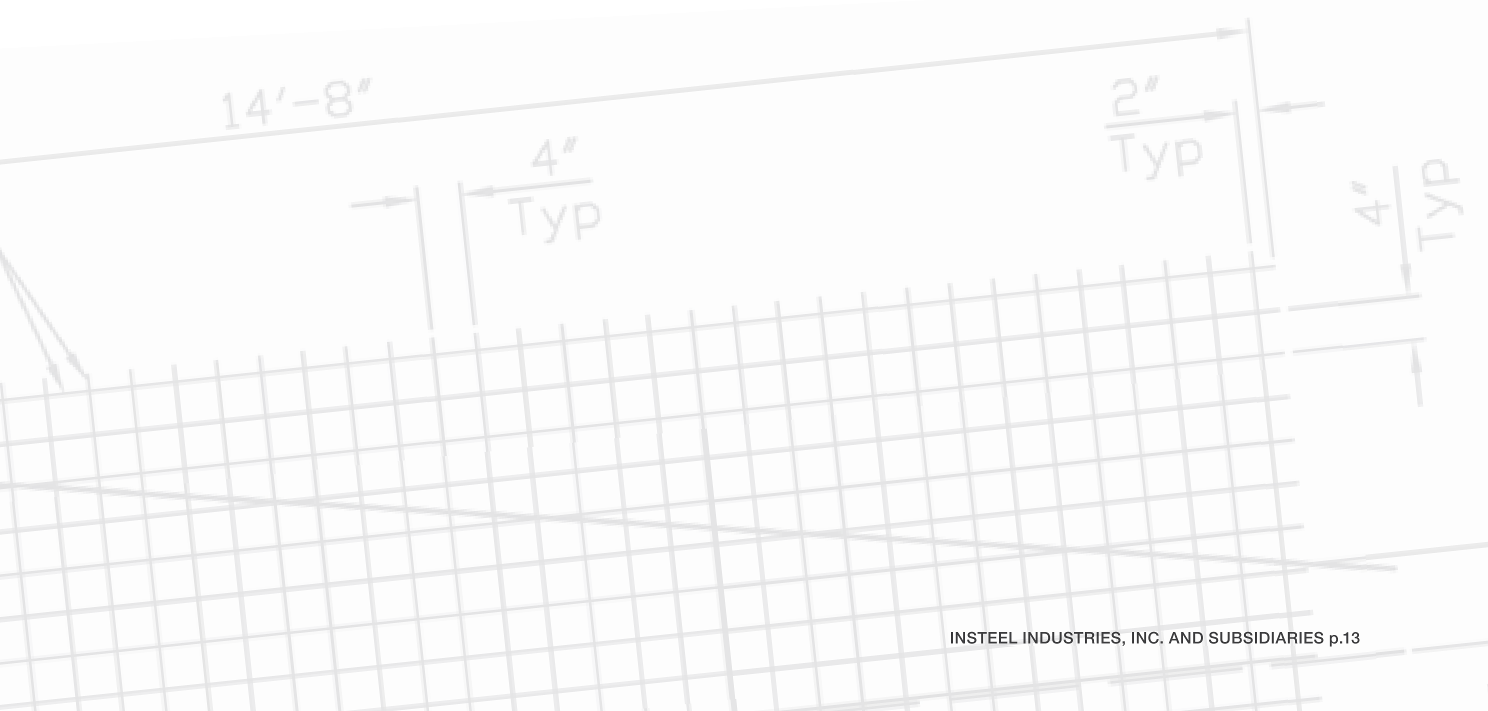

FORWARD-LOOKING STATEMENTS

This annual report contains forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. When used in this report, the words "believes," "anticipates," "expects," "estimates," "intends," "may," "should" and similar expressions are intended to identify forward-looking statements. Although we believe that our plans, intentions and expectations reflected in or suggested by such forward-looking statements are reasonable, such forward-looking statements are subject to a number of risks and uncertainties, and we can provide no assurances that such plans, intentions or expectations will be achieved. All forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by these cautionary statements. All forward-looking statements speak only to the respective dates on which such statements are made and we do not undertake and specifically decline any obligation to publicly release the results of any revisions to these forward-looking statements that may be made to reflect any future events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

It is not possible to anticipate and list all risks and uncertainties that may affect our future operations or financial performance; however, they would include, but are not limited to, the risks discussed below and in our Form 10-K for the year ended September 30, 2006 under the caption "Risk Factors" which includes the following:

- *Our business is cyclical and prolonged economic declines, particularly in the level of construction activity, could have a material adverse effect on our financial results.*
- *Demand for our products is highly variable and difficult to forecast due to our minimal backlog and the unanticipated changes that can occur in customer order patterns or inventory levels.*
- *Our financial results can be negatively impacted by the volatility in the cost and availability of our primary raw material, hot-rolled carbon steel wire rod.*
- *Foreign competition could adversely impact our financial results.*
- *Our manufacturing facilities are subject to unexpected equipment failures, operational interruptions and casualty losses.*
- *Our financial results could be adversely impacted by the continued escalation in certain of our operating costs.*
- *Our capital resources may not be adequate to provide for our capital investment and maintenance expenditures if we were to experience a substantial downturn in our financial performance.*
- *Environmental compliance and remediation could result in substantially increased capital investments and operating costs.*
- *Our production and earnings could be reduced by strikes or work stoppages by our unionized employees.*

OVERVIEW

Following our exit from the industrial wire business (see Note 7 to the consolidated financial statements), our operations are entirely focused on the manufacture and marketing of concrete reinforcing products, including PC strand and welded wire reinforcement for the concrete construction industry. The results of operations for the industrial wire products business have been reported as discontinued operations for all periods presented. Our business strategy is focused on achieving leadership positions in our markets and operating as the lowest cost producer. We pursue growth opportunities in existing or related markets that leverage off of our infrastructure and core competencies in the manufacture and marketing of concrete reinforcing products.

CRITICAL ACCOUNTING POLICIES

Our financial statements have been prepared in accordance with accounting principles generally accepted in the U.S. Our discussion and analysis of our financial condition and results of operations are based on these financial statements. The preparation of our financial statements requires the application of these accounting principles in addition to certain estimates and judgments based on current available information, actuarial estimates, historical results and other assumptions believed to be reasonable. Actual results could differ from these estimates.

The following critical accounting policies are used in the preparation of the financial statements:

Revenue recognition and credit risk. We recognize revenue from product sales in accordance with Staff Accounting Bulletin ("SAB") No. 104 when products are shipped and risk of loss and title has passed to the customer. Substantially all of our accounts receivable are due from customers that are located in the United States and we generally require no collateral depending upon the creditworthiness of the account. We provide an allowance for doubtful accounts based upon our assessment of the credit risk of specific customers, historical trends and other information. There is no disproportionate concentration of credit risk.

Allowance for doubtful accounts. We maintain allowances for doubtful accounts for estimated losses resulting from the potential inability of our customers to make required payments. If the financial condition of our customers were to change significantly, adjustments to the allowances may be required. While we believe our recorded trade receivables will be collected, in the event of default in payment of a trade receivable, we would follow normal collection procedures.

Excess and obsolete inventory reserves. We write down the carrying value of our inventory for estimated obsolescence to reflect the lower of the cost of the inventory or its estimated net realizable value based upon assumptions about future demand and market conditions. If actual market conditions for our products are substantially different than our projections, adjustments to these reserves may be required.

Accruals for self-insured liabilities and litigation. We accrue estimates of the probable costs related to self-insured medical and workers' compensation claims and legal matters. These estimates have been developed in consultation with actuaries, our legal counsel and other advisors and are based on our current understanding of the underlying facts and circumstances. Because of uncertainties related to the ultimate outcome of these issues as well as the possibility of changes in the underlying facts and circumstances, adjustments to these reserves may be required in the future.

Recent accounting pronouncements. In May 2005, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 154, "Accounting Changes and Error Corrections." SFAS No. 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It requires retrospective application of voluntary changes in accounting principles and changes required by accounting pronouncements to the prior periods' financial statements in the event the pronouncement does not include specific transition provisions. SFAS No. 154 is effective for us beginning in fiscal 2007. The adoption of SFAS No. 154 will not have a material impact on our financial position or results of operations.

In June 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN No. 48") which clarifies the criteria for the recognition of tax benefits under SFAS No. 109, "Accounting for Income Taxes." FIN No. 48 specifies how tax benefits for uncertain tax positions are to be recognized, measured and derecognized in financial statements; requires certain disclosures of uncertain tax matters; specifies how reserves for uncertain tax positions should be classified on the balance sheet; and provides transition and interim period guidance, among other provisions. FIN No. 48 is effective for us beginning in fiscal 2008 and requires that the cumulative effect of applying its provisions be disclosed separately as a one-time, non-cash charge against the opening balance of retained earnings in the year of adoption. We are currently evaluating the potential impact of FIN No. 48 on our financial position and results of operations.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" and SFAS No. 158, "Employers Accounting for Defined Benefit Pension and Other Postretirement Plans." 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. SFAS No. 157 is effective for us beginning in fiscal 2009. At this time, we have not determined what effect, if any, the adoption of SFAS No. 157 will have on our financial position or results of operations. SFAS No. 158 requires that an employer recognize the overfunded or underfunded status of a defined benefit postretirement plan in its statement of financial position and changes in the funded status in the year in which the changes occur through other comprehensive income. SFAS No. 158 also requires the measurement of defined benefit plan assets and obligations as of the date of the employer's fiscal year-end statement of financial position. The requirement to recognize the funded status of a benefit plan and the disclosure requirements are effective for us beginning in fiscal 2007. The requirement to measure plan assets and benefit obligations as of the date of the fiscal year-end balance sheet is effective for us beginning in fiscal 2009. At this time, we have not determined what effect, if any, the adoption of SFAS No. 158 will have on our financial position or results of operations.

Also in September 2006, the SEC issued 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 provide guidance on correcting errors in financial statements under the dual approach and do not change the requirements within SFAS No. 154 pertaining to the correction of errors. SAB No. 108 is effective for us beginning in fiscal 2008. We do not expect the adoption of SAB No. 108 to have a material impact on our financial position or results of operations.

RESULTS OF OPERATIONS

Statements of Operations—Selected Data

	Year Ended				
(Dollars in thousands)	(52 weeks) September 30, 2006	Change	(52 weeks) October 1, 2005	Change	(53 weeks) October 2, 2004
Net sales	$329,507	7%	$309,320	4%	$298,754
Gross profit	70,871	22%	57,898	(27%)	78,956
Percentage of net sales	21.5%		18.7%		26.4%
Selling, general and administrative expense	$ 16,996	5%	$ 16,175	(24%)	$ 21,194
Percentage of net sales	5.2%		5.2%		7.1%
Other income, net	(446)	N/M	(73)	N/M	(1,549)
Interest expense	669	(80%)	3,427	(41%)	5,832
Effective income tax rate	36.2%		36.1%		40.1%
Earnings from continuing operations	$ 34,377	40%	$ 24,499	(24%)	$ 32,035
Earnings (loss) from discontinued operations	(1,337)	N/M	546	N/M	(546)
Net earnings	33,040	32%	25,045	(20%)	31,489

"N/M" = not meaningful

2006 COMPARED WITH 2005

Net Sales

Net sales increased 7% to $329.5 million in 2006 from $309.3 million in 2005 as higher shipments more than offset lower average selling prices. Shipments for the year increased 11% while average selling prices decreased 4% from the prior year levels. The increase in shipments was primarily due to the continued improvement in nonresidential construction activity and demand for our concrete reinforcing products during the current year together with the completion of the inventory reduction measures pursued by customers during the prior year. The decrease in average selling prices was due to competitive activity in our markets which was offset by reductions in raw material costs.

Gross Profit

Gross profit increased 22% to $70.9 million, or 21.5% of net sales in 2006 from $57.9 million, or 18.7% of net sales in 2005. The increase in gross profit was driven by higher shipments together with wider spreads between average selling prices and raw material costs. In addition, gross profit for the prior year was negatively impacted by the sale of higher cost inventory as raw material costs and selling prices declined over the course of the year.

Selling, General and Administrative Expense

Selling, general and administrative expense ("SG&A expense") increased 5% to $17.0 million, or 5.2% of net sales in 2006 from $16.2 million, or 5.2% of net sales in 2005. We adopted SFAS No. 123(R) as of the beginning of the current year which requires all share-based payments to be recognized as expense over the requisite service period based upon their fair values as of the grant dates. Under the provisions of SFAS No. 123(R), total stock-based compensation expense for the current year amounted to $1.2 million comprised of $535,000 of stock option expense and $638,000 of restricted stock amortization. Although we elected to adopt SFAS No. 123(R) using the modified prospective method, the prior year amounts also reflect stock option expense due to certain previous option plans that were required to be accounted for as variable plans. Under variable plan accounting, compensation expense was recognized for the excess of the market price over the exercise price and adjusted to reflect changes in market valuation. As a result, total stock-based compensation expense for the prior year amounted to $805,000 comprised of $571,000 of stock option expense resulting from the increase in our share price that occurred during the prior year and $234,000

of restricted stock amortization. Excluding the stock-based compensation expense from both periods, SG&A expense increased $453,000 primarily due to increases in labor costs ($445,000), allowance for doubtful accounts ($299,000), employee benefit costs ($295,000), and travel related expenses ($211,000) partially offset by lower legal expenses ($556,000) and consulting fees ($244,000).

Other Income

Other income was $446,000 in 2006 compared with $73,000 in 2005. The income for the current year was primarily related to a $247,000 litigation settlement and $128,000 of duties related to the dumping and countervailing duty cases that were filed by a coalition of domestic PC strand producers which included us.

Interest Expense

Interest expense decreased $2.8 million, or 80%, to $669,000 in 2006 from $3.4 million in 2005. The decrease was primarily due to the reduction in average borrowing levels on our senior secured credit facility ($1.8 million) and lower amortization expense associated with capitalized financing costs and the unrealized loss on the terminated interest rate swaps which was fully amortized in 2005 ($959,000).

Income Taxes

Our effective income tax rate was relatively flat for 2006 at 36.2% compared with 36.1% in 2005.

Earnings From Continuing Operations

Earnings from continuing operations for 2006 increased to $34.4 million, or $1.86 per diluted share, compared to $24.5 million, or $1.29 per diluted share in 2005 primarily due to the higher sales and gross profit together with the reduction in interest expense in the current year.

Earnings (Loss) From Discontinued Operations

The loss from discontinued operations for 2006 was $1.3 million, or $0.07 per diluted share compared with earnings from discontinued operations of $546,000, or $0.03 per diluted share in 2005. The current year loss related to the operating losses and non-recurring closure costs associated with our exit from the industrial wire business and closure of our Fredericksburg, Virginia manufacturing facility. During the fourth quarter, we completed the sale of certain machinery and equipment associated with the industrial wire business for $6.0 million and recorded a pre-tax gain of $1.3 million. The prior year earnings consisted of a $793,000 gain on the disposal of real estate, the collection of a note receivable and the settlement on the release of an equipment lien associated with Insteel Construction Systems, a discontinued operation that we had previously exited in 1997, partially offset by a loss of $247,000 from the operations of the industrial wire business.

Net Earnings

Net earnings for 2006 increased to $33.0 million, or $1.79 per diluted share, compared to $25.0 million, or $1.32 per diluted share in 2005 primarily due to the higher sales and gross profit together with the reduction in interest expense during the current year which was partially offset by the loss from discontinued operations.

2005 COMPARED WITH 2004

Net Sales

Net sales increased 4% to $309.3 million in 2005 from $298.8 million in 2004 as higher average selling prices for our products more than offset lower shipments. Average selling prices for the year increased 17% while shipments fell 11% from the prior year levels. The increase in selling prices was largely driven by higher raw material costs that we were able to pass through to our customers. The decrease in shipments was primarily due to inventory reduction measures that were pursued by our customers during 2005 which had the effect of reducing orders for our products. Based on our fiscal calendar, sales for 2004 benefited from reflecting one additional week *(2004 was a 53-week fiscal year versus a 52- week fiscal year in 2005)*.

Gross Profit

Gross profit decreased 27% to $57.9 million, or 18.7% of net sales in 2005 from $79.0 million, or 26.4% of net sales in 2004. The decrease in gross profit was largely driven by reduced shipments and higher unit conversion costs resulting from lower production levels which more than offset higher spreads between average selling prices and raw material costs. In addition, gross profit for the current year was negatively impacted by the sale of higher cost inventory as raw material costs and selling prices declined over the course of the year. During the prior year, gross profit benefited from the sale of lower cost inventory in view of the escalation in raw material costs and selling prices.

Selling, General and Administrative Expense

SG&A expense decreased 24% to $16.2 million, or 5.2% of net sales in 2005 from $21.2 million, or 7.1% of net sales in 2004. The decrease in SG&A expense was primarily due to lower compensation expense associated with stock options accounted for as variable awards resulting from the reduced appreciation in our stock price in 2005 ($5.3 million) together with reductions in the allowance for doubtful accounts ($473,000), legal fees ($410,000) and employee benefit costs ($321,000), partially offset by higher expenses related to our Sarbanes-Oxley internal control compliance efforts ($389,000), supplemental employee retirement plan ($277,000), accounting and tax services ($189,000) and bank fees ($152,000).

Other Income

Other income was $73,000 in 2005 compared with $1.5 million in 2004. The income for 2004 was primarily comprised of an $830,000 gain resulting from the settlement of litigation related to a supply agreement with a vendor and $572,000 of profit from the sale of raw material to a vendor.

Interest Expense

Interest expense decreased $2.4 million, or 41%, to $3.4 million in 2005 from $5.8 million in 2004. The decrease was primarily due to reductions in the average borrowing levels on our senior secured credit facility ($1.4 million), average interest rates ($513,000) and capitalized financing costs ($459,000).

Income Taxes

Our effective income tax rate decreased to 36.1% in 2005 from 40.1% in 2004. The lower effective tax rate was primarily due to the reduction in taxable income related to disqualifying dispositions of incentive stock options which are accounted for as variable awards for book purposes. In addition, during 2005 the valuation allowance on deferred income tax assets was reduced based upon our utilization of state net operating loss carryforwards against which an allowance had previously been established.

Earnings From Continuing Operations

Earnings from continuing operations for 2005 decreased to $24.5 million, or $1.29 per diluted share, compared to $32.0 million, or $1.78 per diluted share in 2004 primarily due to the lower gross profit partially offset by the reductions in SG&A and interest expense.

Earnings (Loss) From Discontinued Operations

Earnings from discontinued operations for 2005 were $546,000, or $0.03 per diluted share compared with a loss of $546,000, or $0.03 per diluted share in 2004. The 2005 earnings consisted of a $793,000 gain on the disposal of real estate, the collection of a note receivable and the settlement on the release of an equipment lien associated with Insteel Construction Systems, a discontinued operation that we had previously exited in 1997, partially offset by a loss of $247,000 from the operations of the industrial wire business. The prior year loss was related to the operations of the industrial wire business.

Net Earnings

Net earnings for 2005 decreased to $25.0 million, or $1.32 per diluted share, compared to $31.5 million, or $1.75 per diluted share in 2004 primarily due to the lower gross profit which was partially offset by the reductions in SG&A and interest expense.

LIQUIDITY AND CAPITAL RESOURCES

Selected Financial Data

(Dollars in thousands)	Year Ended (52 weeks) September 30, 2006	(52 weeks) October 1, 2005	(53 weeks) October 2, 2004
Net cash provided by operating activities of continuing operations	$ 42,650	$ 41,830	$ 29,929
Net cash used for investing activities of continuing operations	(19,472)	(6,036)	(2,799)
Net cash used for financing activities of continuing operations	(22,008)	(40,931)	(22,913)
Net cash provided (used for) by operating activities of discontinued operations	2,185	2,630	(1,807)
Net cash provided by (used for) investing activities of discontinued operations	5,963	2,120	(122)
Net cash used for financing activities of discontinued operations	—	(560)	(280)
Working capital	56,938	51,662	61,253
Total long-term debt	—	11,860	52,368
Percentage of total capital	—	11%	42%
Shareholders' equity	$122,438	$ 97,036	$ 71,211
Percentage of total capital	100%	89%	58%
Total capital (total long-term debt plus shareholders' equity)	$122,438	$108,896	$123,579

CASH FLOW ANALYSIS

Operating activities of continuing operations provided $42.7 million of cash in 2006, $41.8 million in 2005 and $29.9 million in 2004. The change in 2006 was largely due to the $9.9 million increase in earnings from continuing operations over the prior year offset by the net change in the working capital components of receivables, inventories, and accounts payable and accrued expenses. For 2006 and 2005, the net change in working capital components provided cash of $4.3 million and $7.9 million, respectively, while using $20.2 million in 2004. The cash provided by working capital in the current year was driven by an $18.5 million increase in accounts payable and accrued expenses primarily due to higher purchases and a more favorable mix of vendor payment terms and a $1.0 million decrease in receivables which was partially offset by a $15.2 million increase in inventories. Total depreciation and amortization decreased $520,000, or 9%, primarily due to the non-recurrence of amortization on unrealized losses originating from the termination of interest rate swap agreements connected with the refinancing of our previous credit facility. Deferred income taxes used $1.6 million during 2006 as compared to providing $2.0 million in 2005 primarily due to higher tax basis gains on the sale of fixed assets.

Investing activities of continuing operations used $19.5 million of cash in 2006, $6.0 million in 2005 and $2.8 million in 2004. Capital expenditures amounted to $19.0 million, $6.3 million and $3.0 million in 2006, 2005 and 2004, respectively, with the increases primarily related to capital outlays for the expansions of the ESM and PC strand businesses. Capital expenditures are expected to be to $18.0 million in 2007 with the largest outlays earmarked for the ESM and PC strand projects. In January 2006, our credit facility was amended to, among other changes, eliminate the annual capital expenditure limitations. The actual timing of these expenditures as well as the amounts are subject to change based on adjustments in the project timelines, future market conditions and our financial performance. Following the completion of the projects that are planned or underway, we believe that maintenance capital expenditures will fall to $3.0 to $5.0 million per year beginning in 2008. In 2006, we completed the sale of certain machinery and equipment associated with our discontinued industrial wire business and recorded the $6.0 million of proceeds in net cash provided by investing activities of discontinued operations.

Financing activities of continuing operations used $22.0 million of cash in 2006, $40.9 million in 2005 and $22.9 million in 2004. During 2006, $11.9 million of long-term debt was repaid, $8.5 million of common stock was repurchased and $2.2 million of cash dividends were paid. Financing activities of discontinued operations did not provide or utilize cash in 2006, as compared to using $560,000 for debt repayment in 2005.

Our total debt-to-capital ratio decreased to 0% at September 30, 2006, compared with 11% at October 1, 2005 and 43% at October 2, 2004. The decrease was due to the repayment of $11.9 million of debt during the current year. The absence of cash flows from discontinued operations is not expected to materially impact our future cash flow or liquidity and was not material in prior years. We believe that, in the absence of significant unanticipated cash demands, net cash generated by operating activities of continuing operations and amounts available under our revolving credit facility will be sufficient to satisfy our expected requirements for working capital, capital expenditures, dividends and share repurchases, if any.

CREDIT FACILITIES

As of September 30, 2006, we had a $100.0 million revolving credit facility in place to supplement our operating cash flow in funding our working capital, capital expenditure and general corporate requirements. During 2006, we repaid the $2.4 million term loan balance previously outstanding on the credit facility as of October 1, 2005. As of September 30, 2006, no borrowings were outstanding on the revolving credit facility and $57.5 million of borrowing capacity was available. Outstanding letters of credit on the revolver totaled $1.4 million as of September 30, 2006 and October 1, 2005.

Advances under the credit facility are limited to the lesser of the revolving credit commitment or a borrowing base amount that is calculated based upon a percentage of eligible receivables and inventories plus, upon our request and subject to certain conditions, a percentage of eligible equipment and real estate. Interest rates on the revolver are based upon (1) a base rate that is established at the higher of the prime rate or 0.50% plus the federal funds rate, or (2) at our election, a LIBOR rate, plus in either case, an applicable interest rate margin. The applicable interest rate margins are adjusted on a quarterly basis based upon the amount of excess availability on the

revolver within the range of 0.00%–0.50% for the base rate and 1.25%–2.00% for the LIBOR rate. In addition, the applicable interest rate margins would be adjusted to the highest percentage indicated for each range upon the occurrence of certain events of default provided for under the credit facility. Based on our excess availability as of September 30, 2006, the applicable interest rate margins on the revolver were 0.00% for the base rate and 1.25% for the LIBOR rate.

In connection with the refinancing of the previous credit facility, we terminated interest rate swap agreements for payments totaling $2.1 million and recorded a corresponding unrealized loss for hedging instruments in the third quarter of fiscal 2004 which, in accordance with GAAP, was amortized and recorded as interest expense through the original termination date of the swap agreement of January 31, 2005.

Our ability to borrow available amounts under the revolving credit facility will be restricted or eliminated in the event of certain covenant breaches, events of default or if we are unable to make certain representations and warranties.

Financial Covenants

The terms of the credit facility require that we maintain a Fixed Charge Coverage Ratio (as defined in the Credit Agreement) of not less than: (1) 1.10 at the end of each fiscal quarter for the twelve-month period then ended when the amount of excess availability on the revolving credit facility is less than $10.0 million and the applicable borrowing base only includes eligible receivables and inventories; or (2) 1.15 at the end of each fiscal quarter for the twelve-month period then ended when the amount of excess availability on the revolving credit facility is less than $10.0 million and the applicable borrowing base includes eligible receivables, inventories, equipment and real estate. As of September 30, 2006, we were in compliance with all of the financial covenants under the credit facility.

Negative Covenants

In addition, the terms of the credit facility restrict our ability to, among other things: engage in certain business combinations or divestitures; make investments in or loans to third parties, unless certain conditions are met with respect to such investments or loans; pay cash dividends or repurchase shares of our stock subject to certain minimum borrowing availability requirements; incur or assume indebtedness; issue securities; enter into certain transactions with our affiliates or permit liens to encumber our property and assets. As of September 30, 2006, we were in compliance with all of the negative covenants under the credit facility.

Events of Default

Under the terms of the credit facility, an event of default will occur with respect to us upon the occurrence of, among other things: a default or breach by us or any of our subsidiaries under any agreement resulting in the acceleration of amounts due in excess of $500,000 under such agreement; certain payment defaults by us or any of our subsidiaries in excess of $500,000; certain events of bankruptcy or insolvency with respect to us, an entry of judgment against us or any of our subsidiaries for greater than $500,000, which amount is not covered by insurance; or a change of control of us.

Previous Amendment to Credit Facility

As reflected in the previously stated terms of the credit facility, on January 12, 2006, the credit facility was amended, increasing the commitment amount from $75.0 million to $100.0 million and extending the maturity date by two years to June 2010. Among other changes, the amendment also: (1) reduced the initial applicable LIBOR-based borrowing rate on the revolver by 100 basis points; (2) reduced the initial unused fee by 12.5 basis points; (3) eliminated the annual capital expenditure limitation and the leverage ratio covenant; and (4) eliminated the restrictions on dividends and share repurchases and the fixed charge coverage ratio covenant subject to the maintenance of certain excess borrowing availability thresholds.

OFF-BALANCE SHEET ARRANGEMENTS

We do not have any material transactions, arrangements, obligations (including contingent obligations), or other relationships with unconsolidated entities or other persons, as defined by Item 303(a)(4) of Regulation S-K of the SEC, that have or are reasonably likely to have a material current or future impact on our financial condition, results of operations, liquidity, capital expenditures, capital resources or significant components of revenues or expenses.

CONTRACTUAL OBLIGATIONS

Our contractual obligations and commitments at September 30, 2006 are as follows:

Payments Due by Period

(In thousands)	Total	Less Than 1 Year	1–3 Years	3–5 Years	More Than 5 Years
Contractual obligations:					
Operating leases	$ 1,004	$ 561	$ 428	$ 15	$ —
Raw material purchase commitments[1]	50,357	50,357	—	—	—
Other unconditional purchase obligations[2]	7,422	7,422	—	—	—
Pension benefit obligations	3,667	419	849	872	1,527
Supplemental employee retirement plan	16,157	80	160	262	15,655
Total	$78,607	$58,839	$1,437	$1,149	$17,182

(1) Non-cancelable fixed price purchase commitments for raw materials.

(2) Contractual commitments for equipment purchases.

OUTLOOK

We believe that the increased demand for our concrete reinforcing products in 2006 was driven by the continued recovery in nonresidential construction spending from the depressed levels of recent years together with the completion of inventory reduction measures within our customer base that reduced order levels during most of 2005. We currently expect that the favorable demand trend for nonresidential construction, which drives an estimated 80% of our sales, will continue and be augmented by: (1) higher government spending for infrastructure-related construction associated with the recent enactment of the transportation funding authorization at the federal level together with the improved fiscal positions of most states and (2) the post-hurricane reconstruction that will be required in the Gulf region of the U.S.

At the same time, the downturn in housing-related markets, which represents an estimated 20% of our sales and significantly reduced our fourth quarter 2006 shipments, is expected to continue as we head into the seasonally slower period of the year. In addition, surging imports of PC strand, particularly from China, and higher cost raw material purchase commitments could result in narrower spreads between average selling prices and raw material costs during the first and second fiscal quarters of 2007 depending on competitive pricing pressures.

Despite these near-term challenges, we expect that business conditions will improve as we move into the second half of 2007 and support the maintenance of gross margins and spreads at attractive levels. We also expect gradually increasing contributions from our PC strand and ESM expansion initiatives in the form of reduced operating costs and additional volume as we progress through 2007, with the Tennessee PC strand expansion anticipated to come on line during the first fiscal quarter followed by the expected start-ups of the ESM expansions in our North Carolina plant during the second fiscal quarter and our Texas plant during the third fiscal quarter. In addition to these organic growth initiatives, we are continually evaluating potential acquisitions in existing or related products that further our penetration in current markets served or expand our geographic presence. We anticipate that these actions, together with the positive overall outlook for our markets, should have a favorable impact on our financial performance in 2007 (see "Forward-Looking Statements").

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our cash flows and earnings are subject to fluctuations resulting from changes in commodity prices, interest rates and foreign exchange rates. We manage our exposure to these market risks through internally established policies and procedures and,

when deemed appropriate, through the use of derivative financial instruments. We do not use financial instruments for trading purposes and we are not a party to any leveraged derivatives. We monitor our underlying market risk exposures on an ongoing basis and believe that we can modify or adapt our hedging strategies as necessary.

Commodity Prices

We do not generally use derivative commodity instruments to hedge our exposures to changes in commodity prices. Our principal commodity price exposure is hot-rolled carbon steel wire rod, our primary raw material, which we purchase from both domestic and foreign suppliers and is denominated in U.S. dollars. Prior to 2004, we typically negotiated quantities and pricing on a quarterly basis for both domestic and foreign steel wire rod purchases to manage our exposure to price fluctuations and to ensure adequate availability of material consistent with our requirements. However, beginning in 2004, a tightening of supply in the rod market together with fluctuations in the raw material costs of rod producers resulted in increased price volatility which has continued through 2006. In some instances, wire rod producers have resorted to increasing the frequency of price adjustments, typically on a monthly basis as well as unilaterally changing the terms of prior commitments. Our ability to acquire steel wire rod from foreign sources on favorable terms is impacted by fluctuations in foreign currency exchange rates, foreign taxes, duties, tariffs and other trade actions. Although changes in wire rod costs and our selling prices may be correlated over extended periods of time, depending upon market conditions, there may be periods during which we are unable to fully recover increased rod costs through higher selling prices, which reduces our gross profit and cash flow from operations.

Interest Rates

Although we were debt-free as of September 30, 2006, future borrowings under our senior secured credit facility are sensitive to changes in interest rates.

Foreign Exchange Exposure

We have not typically hedged foreign currency exposures related to transactions denominated in currencies other than U.S. dollars and any such transactions have not been material in the past. We will occasionally hedge firm commitments for certain equipment purchases that are denominated in foreign currencies. The decision to hedge any such transactions is made by us on a case-by-case basis. There were no forward contracts outstanding as of September 30, 2006.

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Insteel's management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended. Insteel's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. The Company's internal control over financial reporting includes those written policies and procedures that: (1) pertain to maintaining records that in reasonable detail accurately and fairly reflect the transactions and dispositions of assets; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures are made in accordance with authorizations of management and directors; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of Insteel's internal control over financial reporting as of September 30, 2006. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control—Integrated Framework. Based on its assessment, management believes that, as of September 30, 2006, Insteel's internal control over financial reporting was effective based on those criteria.

Grant Thornton LLP, an independent registered public accounting firm, has audited management's assessment of the effectiveness of Insteel's internal control over financial reporting and has issued an attestation report concurring with management's assessment which is on page 25.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM
CONSOLIDATED FINANCIAL STATEMENTS

The Board of Directors and Shareholders
Insteel Industries, Inc.:

We have audited the accompanying consolidated balance sheets of Insteel Industries, Inc. and subsidiary (a North Carolina corporation) as of September 30, 2006 and October 1, 2005 and the related consolidated statements of operations, shareholders' equity and comprehensive income and cash flows for each of the three years in the period ended September 30, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Insteel Industries, Inc. and subsidiary as of September 30, 2006 and October 1, 2005 and the results of their operations and their cash flows for each of the three years in the period ended September 30, 2006, in conformity with accounting principles generally accepted in the United States.

As discussed in Note 2 to the financial statements, the Company has adopted Financial Accounting Standards Board Statement No. 123(R), "Share-Based Payment," (SFAS 123R) for the year ended September 30, 2006.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Insteel Industries, Inc. and subsidiary's internal control over financial reporting as of September 30, 2006 based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated December 6, 2006 expressed an unqualified opinion.

Greensboro, North Carolina
December 6, 2006

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM INTERNAL CONTROL OVER FINANCIAL REPORTING

To the Board of Directors and Shareholders
Insteel Industries, Inc.:

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that Insteel Industries, Inc. and subsidiary (a North Carolina corporation) maintained effective internal control over financial reporting as of September 30, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Insteel Industries, Inc. and subsidiary's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Insteel Industries, Inc. and subsidiary maintained effective internal control over financial reporting as of September 30, 2006, is fairly stated, in all material respects, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also in our opinion, Insteel Industries, Inc. and subsidiary maintained, in all material respects, effective internal control over financial reporting as of September 30, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Insteel Industries, Inc. and subsidiary as of September 30, 2006 and October 1, 2005 and the related consolidated statements of operations, shareholders' equity and comprehensive income and cash flows for each of the three years in the period ended September 30, 2006, and our report dated December 6, 2006, expressed an unqualified opinion on those financial statements.

Greensboro, North Carolina
December 6, 2006

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except for per share amounts)	Year Ended (52 weeks) September 30, 2006	(52 weeks) October 1, 2005	(53 weeks) October 2, 2004
Net sales	$329,507	$309,320	$298,754
Cost of sales	258,636	251,422	219,798
Gross profit	70,871	57,898	78,956
Selling, general and administrative expense	16,996	16,175	21,194
Other income, net	(446)	(73)	(1,549)
Interest expense	669	3,427	5,832
Interest income	(255)	—	(1)
Earnings from continuing operations before income taxes	53,907	38,369	53,480
Income taxes	19,530	13,870	21,445
Earnings from continuing operations	34,377	24,499	32,035
Earnings (loss) from discontinued operations net of income taxes of ($851), $330 and ($310)	(1,337)	546	(546)
Net earnings	$ 33,040	$ 25,045	$ 31,489
Per share amounts:			
Basic:			
Earnings from continuing operations	$ 1.88	$ 1.31	$ 1.85
Earnings (loss) from discontinued operations	(0.08)	0.03	(0.03)
Net earnings	$ 1.80	$ 1.34	$ 1.82
Diluted:			
Earnings from continuing operations	$ 1.86	$ 1.29	$ 1.78
Earnings (loss) from discontinued operations	(0.07)	0.03	(0.03)
Net earnings	$ 1.79	$ 1.32	$ 1.75
Cash dividends declared	$ 0.12	$ 0.06	$ —
Weighted shares outstanding:			
Basic	18,307	18,656	17,284
Diluted	18,473	18,954	17,948

See accompanying notes to consolidated financial statements.

CONSOLIDATED BALANCE SHEETS

(In thousands, except for per share amounts)	September 30, 2006	October 1, 2005
Assets:		
Current assets:		
Cash and cash equivalents	$ 10,689	$ 1,371
Accounts receivable, net	37,519	38,601
Inventories	46,797	31,569
Prepaid expenses and other	2,675	3,647
Current assets of discontinued operations	411	5,829
Total current assets	98,091	81,017
Property, plant and equipment, net	55,217	40,970
Other assets	9,653	7,325
Non-current assets of discontinued operations	3,635	8,964
Total assets	$166,596	$138,276
Liabilities and shareholders' equity:		
Current liabilities:		
Accounts payable	$ 30,691	$ 15,449
Accrued expenses	9,819	9,283
Current portion of long-term debt	—	2,376
Current liabilities of discontinued operations	643	2,247
Total current liabilities	41,153	29,355
Long-term debt	—	9,484
Other liabilities	2,713	2,401
Long-term liabilities of discontinued operations	292	—
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, no par value		
Authorized shares: 1,000		
None issued	—	—
Common stock, $1 stated value		
Authorized shares: 40,000		
Issued and outstanding shares: 2006, 18,213; 2005, 18,860	18,213	18,861
Additional paid-in capital	47,005	45,003
Deferred stock compensation	(662)	(508)
Retained earnings	57,882	34,772
Accumulated other comprehensive loss	—	(1,092)
Total shareholders' equity	122,438	97,036
Total liabilities and shareholders' equity	$166,596	$138,276

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)	Year Ended (52 Weeks) September 30, 2006	(52 Weeks) October 1, 2005	(53 Weeks) October 2, 2004
Cash Flows From Operating Activities:			
Net earnings	$ 33,040	$ 25,045	$ 31,489
Loss (earnings) from discontinued operations	1,337	(546)	546
Earnings from continuing operations	34,377	24,499	32,035
Adjustments to reconcile earnings from continuing operations to net cash provided by operating activities of continuing operations:			
Depreciation and amortization	4,578	4,139	4,259
Amortization of capitalized financing costs	529	651	1,154
Amortization of unrealized loss on financial instruments	—	837	796
Stock-based compensation expense	1,173	805	6,158
Excess tax benefits from exercise of stock options	(459)	—	—
Loss on sale of property, plant and equipment	82	63	52
Deferred income taxes	(1,627)	2,004	7,118
Increase in cash surrender value of life insurance over premiums paid	(193)	—	—
Net changes in assets and liabilities:			
Accounts receivable, net	1,082	481	(11,831)
Inventories	(15,228)	6,753	(9,486)
Accounts payable and accrued expenses	18,456	640	1,076
Other changes	(120)	958	(1,402)
Total adjustments	8,273	17,331	(2,106)
Net cash provided by operating activities—continuing operations	42,650	41,830	29,929
Net cash provided by (used for) operating activities—discontinued operations	2,185	2,630	(1,807)
Net cash provided by operating activities	44,835	44,460	28,122
Cash Flows From Investing Activities:			
Capital expenditures	(18,959)	(6,302)	(2,921)
Proceeds from sale of assets held for sale	—	904	—
Proceeds from sale of property, plant and equipment	52	27	24
Decrease (increase) in cash surrender value of life insurance policies	(565)	(665)	98
Net cash used for investing activities—continuing operations	(19,472)	(6,036)	(2,799)
Net cash provided by (used for) investing activities—discontinued operations	5,963	2,120	(122)
Net cash used for investing activities	(13,509)	(3,916)	(2,921)

(continued)

(In thousands)	Year Ended (52 Weeks) September 30, 2006	(52 Weeks) October 1, 2005	(53 Weeks) October 2, 2004
Cash Flows From Financing Activities:			
Proceeds from long-term debt	135,219	329,562	135,451
Principal payments on long-term debt	(147,079)	(370,070)	(152,536)
Financing costs	(307)	(23)	(3,475)
Cash received from exercise of stock options	360	175	418
Termination of interest rate swaps	—	—	(2,117)
Excess tax benefits from exercise of stock options	459	—	—
Repurchase of common stock	(8,529)	—	—
Cash dividends paid	(2,222)	(566)	—
Other	91	(9)	(654)
Net cash used for financing activities—continuing operations	(22,008)	(40,931)	(22,913)
Net cash used for financing activities—discontinued operations	—	(560)	(280)
Net cash used for financing activities	(22,008)	(41,491)	(23,193)
Net increase (decrease) in cash and cash equivalents	9,318	(947)	2,008
Cash and cash equivalents at beginning of period	1,371	2,318	310
Cash and cash equivalents at end of period	$ 10,689	$ 1,371	$ 2,318
Supplemental Disclosures of Cash Flow Information:			
Cash paid during the period for:			
Interest	$ 202	$ 3,531	$ 7,712
Income taxes	17,489	12,001	13,244
Non-cash financing activity:			
Cashless exercise of stock options	—	338	338
Issuance of restricted stock	792	742	—
Declaration of cash dividends to be paid	543	565	—
Other	—	105	—

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY AND COMPREHENSIVE INCOME

(In thousands)	Common Stock		Additional Paid-In Capital	Deferred Compensation	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income (Loss)[1]	Total Shareholders' Equity
	Shares	Amount					
Balance at September 27, 2003	16,920	$16,920	$38,327	$ —	$(20,562)	$(3,413)	$ 31,272
Comprehensive income:							
Net earnings					31,489		31,489
Change in fair market value of financial instruments						1,211	1,211
Amortization of loss on financial instruments included in net earnings						656	656
Recognition of additional pension plan liability						(91)	(91)
Comprehensive income[1]							33,265
Stock options exercised	1,324	1,324	(906)				418
Compensation expense associated with stock-based plans			6,158				6,158
Excess tax benefits from exercise of stock options			98				98
Balance at October 2, 2004	18,244	$18,244	$43,677	$ —	$ 10,927	$(1,637)	$ 71,211
Comprehensive income:							
Net earnings					25,045		25,045
Amortization of loss on financial instruments included in net earnings						656	656
Recognition of additional pension plan liability						(111)	(111)
Comprehensive income[1]							25,590
Stock options exercised	570	570	(395)				175
Restricted stock granted	82	83	659	(742)			—
Restricted stock shares from dividend			3				3
Compensation expense associated with stock-based plans			571	234			805
Retirement of shares held within grantor trust	(36)	(36)			(69)		(105)
Cash dividends declared					(1,131)		(1,131)
Excess tax benefits from exercise of stock options			488				488
Balance at October 1, 2005	18,860	$18,861	$45,003	$(508)	$ 34,772	$(1,092)	$ 97,036
Comprehensive income:							
Net earnings					33,040		33,040
Reduction in pension liability						1,092	1,092
Comprehensive income[1]							34,132
Stock options exercised	101	101	259				360
Restricted stock granted	51	50	742	(792)			—
Restricted stock shares from dividend	1	1	7				8
Compensation expense associated with stock-based plans			535	638			1,173
Excess tax benefits from exercise of stock options			459				459
Repurchase of common stock	(800)	(800)			(7,729)		(8,529)
Cash dividends declared					(2,201)		(2,201)
Balance at September 30, 2006	**18,213**	**$18,213**	**$47,005**	**$(662)**	**$ 57,882**	**$ —**	**$122,438**

(1) Components of accumulated other comprehensive income (loss) are reported net of related income taxes.

See accompanying notes to consolidated financial statements.

(1) DESCRIPTION OF BUSINESS

Insteel Industries, Inc. ("Insteel" or "the Company") is one of the nation's largest manufacturers of steel wire reinforcing products for concrete construction applications. Insteel is the parent holding company for a wholly-owned operating subsidiary, Insteel Wire Products Company ("IWP"). The Company manufactures and markets PC strand and welded wire reinforcement products, including concrete pipe reinforcement, engineered structural mesh and standard welded wire reinforcement. The Company's products are primarily sold to manufacturers of concrete products and to a lesser extent to numerous distributors and rebar fabricators that are located nationwide as well as into Canada, Mexico, and Central and South America.

The Company's exit from the industrial wire business in June 2006 (see Note 7 to the consolidated financial statements) narrowed its strategic and operational focus to concrete reinforcing products. The results of operations for the industrial wire products business have been reported as discontinued operations for all periods presented.

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Fiscal year. The Company's fiscal year is the 52 or 53 weeks ending on the Saturday closest to September 30. Fiscal years 2006 and 2005 were 52-week fiscal years and fiscal year 2004 was a 53-week fiscal year. All references to years relate to fiscal years rather than calendar years.

Principles of consolidation. The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany balances and transactions have been eliminated.

Use of estimates. The preparation of financial statements in conformity with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. There is no assurance that actual results will not differ from these estimates.

Cash equivalents. The Company considers all highly liquid investments purchased with original maturities of three months or less to be cash equivalents.

Stock options. Effective October 2, 2005, the Company began recording compensation expense associated with stock options and other forms of equity compensation in accordance with Statement of Financial Accounting Standards ("SFAS") No. 123(R), "Share-Based Payment" as interpreted by SEC SAB No. 107. Previously the Company had accounted for stock option plans under the intrinsic value method prescribed by Accounting Principals Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees," and therefore no related compensation expense was recorded for awards granted with no intrinsic value. The Company adopted the modified prospective transition method provided for under SFAS No. 123(R) and consequently, has not retroactively adjusted results from prior periods. Under this transition method, (1) stock compensation expense associated with options granted on or after October 2, 2005 is recorded in accordance with the provisions of SFAS No. 123(R); and (2) stock compensation expense associated with the remaining unvested portion of stock options granted prior to October 2, 2005 is recorded based on the grant date fair value of the options estimated in accordance with the original provisions of SFAS No. 123, "Accounting for Stock-Based Compensation."

As a result of adopting SFAS No. 123(R), the Company recorded $535,000 of compensation expense for stock options within selling, general and administrative expense for the year ended September 30, 2006. This had the effect of reducing earnings from continuing operations before income taxes by $535,000 ($0.03 per basic and diluted share) for the year ended September 30, 2006. The Company recorded $571,000 and $6.2 million of compensation expense for the years ended October 1, 2005 and October 2, 2004, respectively, for stock options associated with certain previous option plans that were required to be accounted for as variable plans under the provisions of APB No. 25. Under variable plan accounting, compensation expense was recognized for the excess of the market price over the exercise price and adjusted each reporting period to reflect changes in market valuation. Under the provisions of SFAS No. 123(R), these options are now accounted for as equity awards and, since the options were fully vested as of October 2, 2005, no compensation expense was recorded in 2006.

Prior to the adoption of SFAS No. 123(R), the benefit of tax deductions in excess of recognized stock compensation expense was reported as a reduction of taxes paid within operating cash flow. SFAS No. 123(R) requires that such benefits be reported as a financing cash flow. For the period ended September 30, 2006, $459,000 of excess tax benefits were generated from option exercises. In addition, upon the adoption of SFAS 123(R), the Company evaluated the need to record a cumulative effect adjustment for estimated forfeitures and determined the amount to be immaterial.

The following table illustrates the effect on net earnings and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to options granted under the Company's option plans for the years ended October 1, 2005 and October 2, 2004:

	Year Ended	
(In thousands, except for per share amounts)	(52 weeks) October 1, 2005	(53 weeks) October 2, 2004
Net earnings—as reported	$25,045	$31,489
Stock-based compensation expense included in reported net earnings, net of related tax effects	(214)	5,226
Total stock-based compensation expense determined under fair-value based method for all awards, net of related tax effects	(141)	(216)
Net earnings—pro forma	$24,690	$36,499
Basic net earnings per share—as reported	$ 1.34	$ 1.82
Basic net earnings per share—pro forma	1.32	2.11
Diluted net earnings per share—as reported	1.32	1.75
Diluted net earnings per share—pro forma	1.30	2.07
Basic shares outstanding—as reported and pro forma	18,656	17,284
Diluted shares outstanding—as reported	18,954	17,948
Diluted shares outstanding—pro forma	18,940	17,636

Revenue recognition and credit risk. The Company recognizes revenue from product sales in accordance with SAB No. 104 when the products are shipped and risk of loss and title has passed to the customer. Substantially all of the Company's accounts receivable are due from customers that are located in the U.S. and the Company generally requires no collateral depending upon the creditworthiness of the account. The Company provides an allowance for doubtful accounts based upon its assessment of the credit risk of specific customers, historical trends and other information. The Company writes off accounts receivable when they become uncollectible and payments subsequently received are credited to the allowance for doubtful accounts. There is no disproportionate concentration of credit risk.

Shipping and handling costs. The Company includes all of the outbound freight, shipping and handling costs associated with the shipment of products to customers in cost of sales. Any amounts paid by customers to the Company for shipping and handling are recorded in net sales on the consolidated statement of operations.

Inventories. Inventories are valued at the lower of average cost (which approximates computation on a first-in, first-out basis) or market (net realizable value or replacement cost).

Property, plant and equipment. Property, plant and equipment are stated at cost or otherwise at reduced values to the extent there have been asset impairment write-downs. Expenditures for maintenance and repairs are charged directly to expense when incurred, while major improvements are capitalized. Depreciation is computed for financial reporting purposes principally by use of the straight-line method over the following estimated useful lives: machinery and equipment, 3–15 years; buildings, 10–30 years; land improvements, 5–15 years. Depreciation expense was approximately $4.6 million in 2006, $4.1 million in 2005 and $4.2 million in 2004. Capitalized software is amortized over the shorter of the estimated useful life or 5 years. No interest costs were capitalized in 2006, 2005 or 2004.

Other assets. Other assets consist principally of non-current deferred tax assets, capitalized financing costs, the cash surrender value of life insurance policies and assets held for sale. Capitalized financing costs are amortized using the straight-line method, which approximates the effective interest method over the life of the related credit agreement.

Long-lived assets. Long-lived assets include property, plant and equipment and identifiable intangible assets with definite useful lives. The Company assesses the impairment of long-lived assets whenever events or changes in circumstance indicate that the carrying value may not be fully recoverable. When the Company determines that the carrying value of such assets may not be recoverable, it measures recoverability based on the undiscounted cash flows expected to be generated by the related asset or asset group. If it is determined that an impairment loss has occurred, the loss is recognized during the period incurred. An impairment loss is calculated as the difference between the carrying value and the present value of estimated future net cash flows or comparable market values. There were no impairment losses in 2006, 2005 or 2004.

Fair value of financial instruments. The carrying amounts for cash and cash equivalents, accounts receivable, and accounts payable and accrued expenses approximate fair value because of their short maturities. The estimated fair value of long-term debt is primarily based upon quoted market prices as well as borrowing rates currently available to the Company for bank loans with similar terms and maturities. The carrying amount of long-term debt approximates its estimated fair value under the Company's senior secured credit facility (see Note 4—Credit Facilities).

Income taxes. Income taxes are based on pretax financial accounting income. Deferred tax assets and liabilities are recognized for the expected tax consequences of temporary differences between the tax bases of assets and liabilities and their reported amounts. The Company periodically assesses the need to establish a valuation allowance against its deferred tax assets to the extent the Company no longer believes it is more likely than not that the tax assets will be fully utilized.

Earnings per share. Basic earnings per share ("EPS") are computed by dividing net earnings by the weighted average number of common shares outstanding during the period. Diluted EPS are computed by dividing net earnings by the weighted average number of common shares and other dilutive equity securities outstanding during the period. Securities that have the effect of increasing EPS are considered to be antidilutive and are not included in the computation of diluted EPS.

Recent accounting pronouncements. In May 2005, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 154, "Accounting Changes and Error Corrections." SFAS No. 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It requires retrospective application of voluntary changes in accounting principle and changes required by accounting pronouncements to the prior periods' financial statements in the event the pronouncement does not include specific transition provisions. SFAS No. 154 is effective for the Company beginning in fiscal 2007. The adoption of SFAS No. 154 will not have a material impact on the Company's financial position or results of operations.

In June 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN No. 48") which clarifies the criteria for the recognition of tax benefits under SFAS No. 109, "Accounting for Income Taxes." FIN No. 48 specifies how tax benefits for uncertain tax positions are to be recognized, measured and derecognized in financial statements; requires certain disclosures of uncertain tax matters; specifies how reserves for uncertain tax positions should be classified on the balance sheet; and provides transition and interim period guidance, among other provisions. FIN No. 48 is effective for the Company beginning in fiscal 2008 and requires that the cumulative effect of applying its provisions be disclosed separately as a one-time, non-cash charge against the opening balance of retained earnings in the year of adoption. The Company is currently evaluating the potential impact of FIN No. 48 on its financial position and results of operations.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" and SFAS No. 158, "Employers Accounting for Defined Benefit Pension and Other Postretirement Plans." 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. SFAS No. 157 is effective for the Company beginning in fiscal 2009. At this time, the Company has not determined what effect, if any, the adoption of SFAS No. 157 will have on its financial position or results of operations. SFAS No. 158 requires that an employer recognize the overfunded or underfunded status of a defined benefit postretirement plan in its statement of financial position and changes in the funded status in the year in which the changes occur through other comprehensive income. SFAS No. 158 also requires the measurement of defined benefit plan assets and obligations as of the date of the employer's fiscal year-end statement of financial position. The requirement to recognize the funded status of a benefit plan and the disclosure requirements are effective for the Company beginning in fiscal 2007. The requirement to measure plan assets and benefit obligations as of the date of the fiscal year-end balance sheet is effective for the Company beginning in fiscal 2009. At this time, the Company has not determined what effect, if any, the adoption of SFAS No. 158 will have on its financial position or results of operations.

Also in September 2006, the SEC issued 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 provide guidance on correcting errors in financial statements under the dual approach and do not change the requirements within SFAS No. 154 pertaining to the correction of errors. SAB No. 108 is effective for the Company beginning in fiscal 2008. The Company does not expect the adoption of SAB No. 108 to have a material impact on its financial position or results of operations.

(3) STOCK SPLIT

On May 16, 2006, the Board of Directors approved a two-for-one split of the Company's common stock payable in the form of a stock dividend. The stock split entitled each shareholder of record on June 2, 2006 to receive one share of common stock for every outstanding share of common stock held on that date and was distributed on June 16, 2006. Unless otherwise indicated, the capital stock accounts and all share and earnings per share amounts in this report give effect to the stock split, applied retroactively, to all periods presented.

(4) CREDIT FACILITIES

As of September 30, 2006, the Company had a $100.0 million revolving credit facility in place to supplement its operating cash flow in funding its working capital, capital expenditure and general corporate requirements. During 2006, the Company repaid the $2.4 million term loan balance previously outstanding on the credit facility as of October 1, 2005. As of September 30, 2006, no borrowings were outstanding on the revolving credit facility and $57.5 million of borrowing capacity was available. Outstanding letters of credit on the revolver totaled $1.4 million as of September 30, 2006 and October 1, 2005.

Advances under the credit facility are limited to the lesser of the revolving credit commitment or a borrowing base amount that is calculated based upon a percentage of eligible receivables and inventories plus, upon the Company's request and subject to certain conditions, a percentage of eligible equipment and real estate. Interest rates on the revolver are based upon (1) a base rate that is established at the higher of the prime rate or 0.50% plus the federal funds rate, or (2) at the election of the Company, a LIBOR rate, plus in either case, an applicable interest rate margin. The applicable interest rate margins are adjusted on a quarterly basis based upon the amount of excess availability on the revolver within the range of 0.00%–0.50% for the base rate and 1.25%–2.00% for the LIBOR rate. In addition, the applicable interest rate

margins would be adjusted to the highest percentage indicated for each range upon the occurrence of certain events of default provided for under the credit facility. Based on the Company's excess availability as of September 30, 2006, the applicable interest rate margins were 0.00% for the base rate and 1.25% for the LIBOR rate on the revolver.

In connection with the refinancing of the previous credit facility, the Company terminated interest rate swap agreements for payments totaling $2.1 million and recorded a corresponding unrealized loss for hedging instruments in the third quarter of fiscal 2004 which, in accordance with GAAP, was amortized and recorded as interest expense through the original termination date of the swap agreement of January 31, 2005.

The Company's ability to borrow available amounts under the revolving credit facility will be restricted or eliminated in the event of certain covenant breaches, events of default or if the Company is unable to make certain representations and warranties.

Financial Covenants

The terms of the credit facility require the Company to maintain a Fixed Charge Coverage Ratio (as defined in the Credit Agreement) of not less than: (1) 1.10 at the end of each fiscal quarter for the twelve-month period then ended when the amount of excess availability on the revolving credit facility is less than $10.0 million and the applicable borrowing base only includes eligible receivables and inventories; or (2) 1.15 at the end of each fiscal quarter for the twelve-month period then ended when the amount of excess availability on the revolving credit facility is less than $10.0 million and the applicable borrowing base includes eligible receivables, inventories, equipment and real estate. As of September 30, 2006, the Company was in compliance with all of the financial covenants under the credit facility.

Negative Covenants

In addition, the terms of the credit facility restrict the Company's ability to, among other things: engage in certain business combinations or divestitures; make investments in or loans to third parties, unless certain conditions are met with respect to such investments or loans; pay cash dividends or repurchase shares of the Company's stock subject to certain minimum borrowing availability requirements; incur or assume indebtedness; issue securities; enter into certain transactions with affiliates of the Company; or permit liens to encumber the Company's property and assets. As of September 30, 2006, the Company was in compliance with all of the negative covenants under the credit facility.

Events of Default

Under the terms of the credit facility, an event of default will occur with respect to the Company upon the occurrence of, among other things: a default or breach by the Company or any of its subsidiaries under any agreement resulting in the acceleration of amounts due in excess of $500,000 under such agreement; certain payment defaults by the Company or any of its subsidiaries in excess of $500,000; certain events of bankruptcy or insolvency with respect to the Company; an entry of judgment against the Company or any of its subsidiaries for greater than $500,000, which amount is not covered by insurance; or a change of control of the Company.

Previous Amendment to Credit Facility

As reflected in the previously stated terms of the credit facility, on January 12, 2006, the credit facility was amended, increasing the commitment amount from $75.0 million to $100.0 million and extending the maturity date by two years to June 2010. Among other changes, the amendment also: (1) reduced the initial applicable LIBOR-based borrowing rate on the revolver by 100 basis points; (2) reduced the initial unused fee by 12.5 basis points; (3) eliminated the annual capital expenditure limitation and the leverage ratio covenant; and (4) eliminated the restrictions on dividends and share repurchases and the fixed charge coverage ratio covenant subject to the maintenance of certain excess borrowing availability thresholds.

Amortization of capitalized financing costs associated with the senior secured facility was $529,000 in 2006, $651,000 million in 2005 and $1.2 million in 2004. The Company expects the amortization of capitalized financing costs to approximate the following amounts for the next five fiscal years:

Fiscal year	(In thousands)
2007	$499
2008	499
2009	508
2010	336
2011	—

(5) STOCK OPTION PLANS

The Company has stock option plans under which employees and directors may be granted options to purchase shares of common stock at the fair market value on the date of the grant. Options granted under these plans generally vest over three years and expire ten years from the date of the grant. The fair value of each option award granted prior to October 1, 2005 was estimated on the date of grant using a Black-Scholes option-pricing model. With the adoption of SFAS 123(R), the Company determined that it would use a Monte Carlo valuation model for options that are granted subsequent to October 1, 2005. The weighted-average estimated fair values of stock options granted during 2006, 2005, and 2004 were $8.82, $7.74 and $5.36 per share, respectively, based on the following weighted-average assumptions:

	Year Ended		
	September 30, 2006	October 1, 2005	October 2, 2004
Expected term (in years)	3.20	7.00	5.00
Risk-free interest rate	4.82%	4.14%	3.68%
Expected volatility	74.72%	180.40%	221.00%
Expected dividend yield	0.70%	0.79%	0.00%

The assumptions utilized in the model are evaluated and revised, as necessary, to reflect market conditions and actual historical experience. The risk-free interest rate for periods within the contractual life of the option was based on the U.S. Treasury yield curve in effect at the time of the grant. The dividend yield was calculated based on the Company's annual dividend as of the option grant date. The expected volatility was derived using a term structure based on historical volatility and the volatility implied by exchange-traded options on the Company's stock. The expected term for options was based on the results of a Monte Carlo simulation model, using the model's estimated fair value as an input to the Black-Scholes-Merton model, and then solving for the expected term.

At September 30, 2006, there were 1,484,000 shares available for future grants under the Company's equity incentive plans. The following table summarizes stock option activity during 2004, 2005 and 2006:

(Share amounts in thousands)	Options Outstanding	Exercise Price Per Share: Range	Exercise Price Per Share: Weighted Average	Contractual Term—Weighted Average	Aggregate Intrinsic Value (in thousands)
Outstanding at September 27, 2003	2,368	$0.18 – $ 4.60	$ 1.34		
Granted	50	5.43 – 5.43	5.43		
Exercised	(1,480)	0.18 – 4.60	0.83		$3,981
Outstanding at October 2, 2004	938	0.18 – 5.43	2.36		
Granted	96	6.89 – 9.12	8.24		
Exercised	(706)	0.18 – 5.43	2.17		4,762
Outstanding at October 1, 2005	328	0.18 – 9.12	4.48		
Granted	55	15.64 – 20.26	17.54		
Exercised	(101)	0.18 – 9.12	3.56		1,396
Outstanding at September 30, 2006	282	0.18 – 20.26	7.37	6.62 years	3,526
Vested and anticipated to vest in future at September 30, 2006	278	0.18 – 20.26	7.29	6.59 years	3,505
Exercisable at September 30, 2006	168	0.18 – 9.12	3.72	4.96 years	2,706

The remaining unrecognized compensation costs related to unvested awards at September 30, 2006 is $450,000 which is expected to be recognized over a weighted average period of 1.4 years. The total fair value of shares vested during the years ended September 30, 2006, October 1, 2005, and October 2, 2004 was $290,000, $90,000, and $447,000, respectively.

Restricted Stock. During the years ended September 30, 2006 and October 1, 2005, the Company granted 51,000 and 82,000 shares of restricted stock, respectively, to key employees and directors which had a total market value of $792,000 and $742,000, respectively, as of the grant date. The following table summarizes restricted stock activity during 2005 and 2006:

(Share amounts in thousands)	Restricted Stock Awards Outstanding	Weighted Average Grant Date Fair Value
Balance, October 2, 2004	—	$ —
Granted	82	8.98
Released	—	—
Balance, October 1, 2005	82	8.98
Granted	51	15.64
Released	(30)	8.72
Balance, September 30, 2006	**103**	**12.27**

The Company recorded amortization expense pertaining to restricted stock of $638,000 and $234,000 for the years ended September 30, 2006 and October 1, 2005, respectively. The Company will continue to amortize the remaining unamortized balance over the vesting period of one to three years.

(6) INCOME TAXES

The components of the provision for income taxes on continuing operations are as follows:

(Dollars in thousands)	Year Ended (52 weeks) September 30, 2006	(52 weeks) October 1, 2005	(53 weeks) October 2, 2004
Provision for income taxes:			
Current:			
Federal	**$18,603**	$10,457	$12,312
State	**2,554**	1,409	2,015
	21,157	11,866	14,327
Deferred:			
Federal	**(1,437)**	1,802	6,493
State	**(190)**	202	625
	(1,627)	2,004	7,118
Provision for income taxes	**$19,530**	$13,870	$21,445
Effective income tax rate	**36.2%**	36.1%	40.1%

The reconciliation between income taxes computed at the federal statutory rate and the provision for income taxes on continuing operations is as follows:

(Dollars in thousands)	Year Ended (52 weeks) September 30, 2006		(52 weeks) October 1, 2005		(53 weeks) October 2, 2004	
Provision for income taxes at federal statutory rate	**$18,867**	**35.0%**	$13,429	35.0%	$18,718	35.0%
State income taxes, net of federal tax benefit	**1,381**	**2.6**	1,166	3.0	1,604	3.0
Qualified production activities deduction	**(490)**	**(0.9)**	—	—	—	—
Other permanent book and tax differences, net	**—**	**—**	77	0.2	(7)	—
Stock options expense (benefit)	**151**	**0.3**	(575)	(1.5)	1,411	2.6
Valuation allowance	**(37)**	**(0.1)**	(227)	(0.6)	(414)	(0.8)
Revisions to estimates based on filing of final tax return	**(21)**	**(0.1)**	—	—	(174)	(0.3)
Other, net	**(321)**	**(0.6)**	—	—	307	0.6
Provision for income taxes	**$19,530**	**36.2%**	$13,870	36.1%	$21,445	40.1%

The components of deferred tax assets and liabilities are as follows:

(In thousands)	September 30, 2006	October 1, 2005
Deferred tax assets:		
Accrued expenses or asset reserves for financial statements, not yet deductible for tax purposes	$ 2,440	$ 1,456
State net operating loss carryforwards	944	944
Goodwill, amortizable for tax purposes	2,686	3,017
Nonqualified stock options not deductible in current year	204	333
Valuation allowance	(599)	(636)
Gross deferred tax assets	5,675	5,114
Deferred tax liabilities:		
Plant and equipment principally due to differences in depreciation and impairment charges	(1,467)	(2,111)
Other reserves	(800)	(551)
Gross deferred tax liabilities	(2,267)	(2,662)
Net deferred tax asset	$ 3,408	$ 2,452

The Company has recorded the following amounts for deferred taxes on its consolidated balance sheets as of September 30, 2006 and October 1, 2005: a current deferred tax asset (net of valuation allowance) of $1.2 million and $950,000, respectively, in prepaid expenses and other, and a noncurrent deferred tax asset (net of valuation allowance) of $2.2 million and $1.5 million, respectively, in other assets. The Company has $15.9 million of gross state operating loss carryforwards that begin to expire in seven years, but principally expire in 16–17 years.

The realization of the Company's deferred tax assets is entirely dependent upon the Company's ability to generate future taxable income in applicable jurisdictions. Generally accepted accounting principles ("GAAP") require that the Company periodically assess the need to establish a valuation allowance against its deferred tax assets to the extent the Company no longer believes it is more likely than not that they will be fully utilized. As of September 30, 2006, the Company had recorded a valuation allowance of $599,000 pertaining to various state NOLs that were not anticipated to be utilized. During 2006, the valuation allowance was reduced by $37,000 based on the anticipated utilization of a portion of the remaining losses in future years. The valuation allowance established by the Company is subject to periodic review and adjustment based on changes in facts and circumstances and would be reduced should the Company utilize the state net operating loss carryforwards against which an allowance had been provided.

(7) DISCONTINUED OPERATIONS

In April 2006, the Company decided to exit the industrial wire business with the closure of its Fredericksburg, Virginia facility which manufactured tire bead wire and other industrial wire for commercial and industrial applications. The Company's decision was based on the weakening in the business outlook for the facility and the expected continuation of difficult market conditions and reduced operating levels. Manufacturing activities at the Virginia facility ceased in June 2006 and the Company is currently in the process of liquidating the remaining assets of the business.

The Company has determined that the exit from the industrial wire business meets the criteria of a discontinued operation in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." Accordingly, the results of operations and related non-recurring closure costs associated with the industrial wire business have been reported as discontinued operations for all periods presented. Additionally, the assets and liabilities of the discontinued operations have been segregated in the accompanying consolidated balance sheets.

The following table summarizes the results of discontinued operations for the years ended September 30, 2006, October 1, 2005 and October 2, 2004, respectively:

	Year Ended		
(In thousands)	(52 Weeks) September 30, 2006	(52 Weeks) October 1, 2005	(53 Weeks) October 2, 2004
Net sales	$22,544	$36,216	$33,878
Earnings (loss) before income taxes	(2,188)	876	(856)
Income taxes	851	(330)	310
Net earnings (loss)	(1,337)	546	(546)

Included within results from discontinued operations is an allocation of interest expense which was calculated based on the net assets of the industrial wire business relative to the consolidated net assets of the Company. Interest expense allocated to discontinued operations was $64,000, $802,000 and $3.1 million for the years ended September 30, 2006, October 1, 2005 and October 2, 2004, respectively.

The net loss from discontinued operations for the year ended September 30, 2006 includes a pre-tax gain of $1.3 million on the sale of certain machinery and equipment associated with the industrial wire business. The net earnings from discontinued operations for the year ended October 1, 2005 includes a pre-tax gain of $1.3 million relating to the disposal of real estate, the collection of a note receivable, and the settlement on the release of an equipment lien associated with Insteel Construction Systems ("ICS"), a discontinued operation that the Company had previously exited in 1997.

Assets and liabilities of discontinued operations as of September 30, 2006 and October 1, 2005 are as follows:

(In thousands)	September 30, 2006	October 1, 2005
Assets:		
Current Assets		
Cash and cash equivalents	$ —	$ 1
Accounts receivable, net	407	4,221
Inventories	—	1,591
Prepaid expenses and other	4	16
Total current assets	411	5,829
Other assets	3,635	—
Property, plant and equipment, net	—	8,964
Total assets	$4,046	$14,793
Liabilities:		
Current liabilities:		
Accounts payable	$ 25	$ 1,954
Accrued expenses	618	293
Total current liabilities	643	2,247
Other liabilities	292	—
Total liabilities	$ 935	$ 2,247

As of September 30, 2006 there was approximately $618,000 of accrued expenses and other liabilities related to ongoing lease obligations and closure-related liabilities incurred as a result of the Company's exit from the industrial wire business.

(8) EMPLOYEE BENEFIT PLANS

Retirement plans. The Company has one defined benefit pension plan, the Insteel Wire Products Company Retirement Income Plan for Hourly Employees, Wilmington, Delaware ("the Delaware Plan"). The Delaware Plan provides benefits for eligible employees based primarily upon years of service and compensation levels. The Company's funding policy is to contribute amounts at least equal to those required by law. The Company contributed $1.3 million to the Delaware Plan in 2006 and expects to contribute $290,000 in 2007.

The reconciliation of the projected benefit obligation, plan assets, the funded status of the plan and the amounts recognized in the Company's consolidated balance sheets at September 30, 2006, October 1, 2005 and October 2, 2004 is as follows:

	Year Ended		
(In thousands)	(52 weeks) September 30, 2006	(52 weeks) October 1, 2005	(53 weeks) October 2, 2004
Change in benefit obligation:			
Benefit obligation at beginning of year	$4,702	$ 4,036	$ 4,043
Service cost	82	91	106
Interest cost	253	268	275
Actuarial loss (gain)	(306)	512	281
Distributions	(204)	(205)	(669)
Benefit obligation at end of year	$4,527	$ 4,702	$ 4,036
Change in plan assets:			
Fair value of plan assets at beginning of year	$3,334	$ 2,633	$ 2,551
Actual return on plan assets	79	350	179
Employer contributions	1,318	556	572
Distributions	(204)	(205)	(669)
Fair value of plan assets at end of year	$4,527	$ 3,334	$ 2,633
Reconciliation of funded status to net amount recognized:			
Funded status	$ —	$(1,368)	$(1,403)
Unrecognized net gain	1,476	1,762	1,532
Unrecognized prior service cost	2	2	5
Net amount recognized	$1,478	$ 396	$ 134
Amounts recognized in the consolidated balance sheet consist of:			
Prepaid pension asset	$1,478	$ 396	$ 134
Accrued benefit liability	—	(1,764)	(1,538)
Intangible asset related to prior service cost	—	2	5
Accumulated other comprehensive loss	—	1,092	981
Deferred tax asset—noncurrent	—	670	552
Net amount recognized	$1,478	$ 396	$ 134

Net periodic pension cost includes the following components:

	Year Ended		
(In thousands)	(52 weeks) September 30, 2006	(52 weeks) October 1, 2005	(53 weeks) October 2, 2004
Service cost	$ 82	$ 91	$ 106
Interest cost	253	268	275
Expected return on plan assets	(243)	(217)	(217)
Amortization of prior service cost	1	3	3
Recognized net actuarial loss	143	151	140
Net periodic pension cost	$ 236	$ 296	$ 307

The assumptions used in the valuation of the plan are as follows:

	Measurement Date		
	September 30, 2006	October 1, 2005	October 2, 2004
Assumptions at year-end:			
Discount rate	6.25%	6.00%	6.50%
Rate of increase in compensation levels	N/A	N/A	N/A
Expected long-term rate of return on assets	8.00%	8.00%	8.00%

The projected benefit payments under the plan are as follows:

Fiscal year(s)	(In thousands)
2007	$ 419
2008	424
2009	425
2010	433
2011	439
2012–2016	1,527

The Delaware Plan has a long-term target asset mix of 65% equities and 35% fixed income. The ranges for the long-term allocation are: equities 60% to 80%, fixed income 20% to 40% and cash reserves 0 to 10%. The investment strategy for equities emphasizes U.S. large cap equities with the portfolio's performance measured against the S&P 500 index or other applicable indices. The investment strategy for fixed income investments is focused on maintaining an overall portfolio with a minimum credit rating of A-1 as well as a minimum rating of any security at the time of purchase of Baa/BBB by Moody's or Standard & Poor's, if rated. The total fund has an expected return of 8.0% based on the overall policy allocation and historical market returns, compared to the expected long-term rate of return of 8.0% used to develop the plan's net periodic pension cost.

Supplemental employee retirement plan. The Company has Retirement Security Agreements (each, a "SERP") with certain of its employees (each, a "Participant"). Under the SERP, if the Participant remains in continuous service with the Company for a period of at least 30 years, the Company will pay to the Participant a supplemental retirement benefit for the 15-year period following the Participant's retirement equal to 50% of the Participant's highest average annual base salary for five consecutive years in the 10-year period preceding the Participant's retirement. If the Participant retires prior to the later of age 65 or the completion of 30 years of continuous service with the Company, but has completed at least 10 years of continuous service with the Company, the amount of the supplemental retirement benefit will be reduced by 1/360th for each month short of 30 years that the Participant was employed by the Company. In 2005, the Company amended the SERP to add Participants and increase benefits to certain Participants already included in the plan. The following table provides a reconciliation of the projected benefit obligation for the amended SERP:

	Year Ended	
(In thousands)	September 30, 2006	October 1, 2005
Change in benefit obligation:		
Benefit obligation at beginning of year	$1,263	$ 811
Service cost	372	425
Interest cost	87	67
Distributions	(80)	(40)
Benefit obligation at end of year	$1,642	$1,263

The assumptions used in the valuation of the SERP are as follows:

	Measurement Date	
	December 1, 2005	December 1, 2004
Assumptions at year-end:		
Discount rate	5.6%	5.6%
Rate of increase in compensation levels	3.0%	3.0%

The projected benefit payments are as follows:

Fiscal year(s)	(In thousands)
2007	$ 80
2008	80
2009	80
2010	80
2011	182
2012–2016	1,293

As noted above, the SERP was amended in 2005 to add Participants and increase benefits to certain Participants already included in the plan. However, for certain Participants the Company still maintains the benefits of the SERP that were in effect prior to the 2005 amendment. These Participants are entitled to fixed cash benefits upon retirement at age 65, payable annually for 15 years. This plan is supported by life insurance polices on the Participants purchased by the Company. The cash benefits paid under this plan were $74,000 in 2006, $74,000 in 2005 and $53,000 in 2004. The plan expense was $10,000 in 2006, $3,000 in 2005 and $178,000 in 2004.

Retirement savings plan. In 1996, the Company adopted the Retirement Savings Plan of Insteel Industries, Inc. ("the Plan") to provide retirement benefits and stock ownership for its employees. The Plan is an amendment and restatement of the Company's Employee Stock Ownership Plan ("ESOP"). As allowed under Sections 401(a) and 401(k) of the Internal Revenue Code, the Plan provides for tax-deferred salary deductions for eligible employees.

Employees may contribute up to 15% of their annual compensation to the Plan, limited to a maximum annual amount as set periodically by the Internal Revenue Code. The Plan allows for discretionary contributions to be made by the Company as determined by the Board of Directors. Such contributions to the Plan are allocated among eligible participants based on their compensation relative to the total compensation of all participants. In 2006, 2005 and 2004, the Company matched employee contributions up to 50% of the first 5% of eligible compensation that was contributed by employees. Company contributions to the Plan were $351,000 in 2006, $265,000 in 2005 and $261,000 in 2004.

VEBA. The Company has a Voluntary Employee Beneficiary Association ("VEBA"). Under the plan, both employees and the Company may make contributions to pay for medical costs. Company contributions to the VEBA were $3.1 million in 2006, $2.5 million in 2005 and $3.2 million in 2004. The Company is primarily self-insured for employee's healthcare costs, carrying stop-loss insurance coverage for individual claims in excess of $150,000. The Company's self-insurance liabilities are based on the total estimated costs of claims filed and claims incurred but not reported, less amounts paid against such claims. Management reviews current and historical claims data in developing its estimates.

(9) COMMITMENTS AND CONTINGENCIES

Leases and purchase commitments. The Company leases a portion of its equipment under operating leases that expire at various dates through 2010. Under most lease agreements, the Company pays insurance, taxes and maintenance. Rental expense for operating leases was $836,000 in 2006, $701,000 in 2005 and $684,000 in 2004. Minimum rental commitments under all non-cancelable leases with an initial term in excess of one year are payable as follows: 2007, $561,000; 2008, $340,000; 2009, $88,000; 2010, $15,000; 2011 and beyond $0.

As of September 30, 2006, the Company had $50.4 million in non-cancelable fixed price purchase commitments for raw material extending as long as approximately 120 days. In addition, the Company has contractual commitments for the purchase of certain equipment. Portions of such contracts not completed at year-end are not reflected in the consolidated financial statements and amounted to $7.4 million as of September 30, 2006.

Legal proceedings. The Company is involved in lawsuits, claims, investigations and proceedings, including commercial, environmental and employment matters, which arise in the ordinary course of business. The Company does not expect that the ultimate costs to resolve these matters will have a material adverse effect on its financial position, results of operations or cash flows.

Severance and change of control agreements. The Company has entered into severance agreements with its Chief Executive Officer and Chief Financial Officer that provide certain termination benefits to these executives in the event that an executive's employment with the Company is terminated without cause. The initial term of each agreement is two years and the agreements provide for an automatic renewal of one year unless the Company or the executive provides notice of termination as specified in the agreement. Under the terms of these agreements, in the event of termination without cause, the executives would receive termination benefits equal to one and one-half times the executive's annual base salary in effect on the termination date and the continuation of health and welfare benefits for eighteen months. In addition, all of the executive's stock options would vest immediately and outplacement services would be provided.

The Company has also entered into change of control agreements with key members of management including its executive officers, which specify the terms of separation in the event that termination of employment followed a change in control of the Company. The initial term of each agreement is two years and the agreements provide for an automatic renewal of one year unless the Company or the executive provides notice of termination as specified in the agreement. The agreements do not provide assurances of continued employment, nor do they specify the terms of an executive's termination should the termination occur in the absence of a change in control. Under the terms of these agreements, in the event of termination within two years of a change of control, the Chief Executive Officer and Chief Financial Officer would receive severance benefits equal to two times base compensation, two times the average bonus for the prior three years and the continuation of health and welfare benefits for two years. The Vice President—Administration would receive severance benefits equal to one times base compensation, one times the average bonus for the prior three years and the continuation of health and welfare benefits for one year. In addition, all of the executive's stock options would vest immediately and outplacement services would be provided.

(10) EARNINGS PER SHARE

The reconciliation of basic and diluted earnings per share ("EPS") is as follows:

	Year Ended		
(In thousands, except for per share amounts)	(52 weeks) September 30, 2006	(52 weeks) October 1, 2005	(53 weeks) October 2, 2004
Net earnings	$33,040	$25,045	$31,489
Weighted average shares outstanding:			
Weighted average shares outstanding (basic)	18,307	18,656	17,284
Dilutive effect of stock-based compensation	166	298	664
Weighted average shares outstanding (diluted)	18,473	18,954	17,948
Per share (basic):			
Earnings from continuing operations	$ 1.88	$ 1.31	$ 1.85
Earnings (loss) from discontinued operations	(0.08)	0.03	(0.03)
Net earnings	$ 1.80	$ 1.34	$ 1.82
Per share (diluted):			
Earnings from continuing operations	$ 1.86	$ 1.29	$ 1.78
Earnings (loss) from discontinued operations	(0.07)	0.03	(0.03)
Net earnings	$ 1.79	$ 1.32	$ 1.75

Options to purchase 42,000 shares in 2006, 34,000 shares in 2005 and 38,000 shares in 2004 were antidilutive and were not included in the diluted EPS computation.

(11) BUSINESS SEGMENT INFORMATION

Following the Company's exit from the industrial wire business (see Note 7 to the consolidated financial statements), the Company's operations are entirely focused on the manufacture and marketing of concrete reinforcing products, including PC strand and welded wire reinforcement, for the concrete construction industry. Based on the criteria specified in SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," the Company has one reportable segment. The results of operations for the industrial wire products business have been reported as discontinued operations for all periods presented.

(12) RELATED PARTY TRANSACTIONS

In connection with the Company's stock repurchase program, on January 30, 2006, the Company repurchased approximately 400,000 shares of its common stock held by Howard O. Woltz, Jr., chairman of the Company's board of directors, and his wife. The purchase price for the shares repurchased was $21.322 per share based on a predetermined formula, which represented a 15% discount from the closing price on January 27, 2006. The number of shares repurchased and purchase price per share are prior to the effect of the two-for-one split of the Company's common stock that was distributed as a stock dividend on June 16, 2006.

Sales to a company affiliated with one of the Company's directors amounted to $929,000 in 2006, $701,000 in 2005 and $718,000 in 2004. Purchases from a company affiliated with one of the Company's directors amounted to $1.5 million in 2006.

(13) COMPREHENSIVE LOSS

The components of accumulated other comprehensive loss are as follows:

(In thousands)	September 30, 2006	October 1, 2005
Fair market value of financial instruments	$ —	$ —
Additional pension plan liability	—	(1,092)
Accumulated other comprehensive loss	$ —	$(1,092)

(14) OTHER FINANCIAL DATA

Balance sheet information:

(In thousands)	September 30, 2006	October 1, 2005
Accounts receivable, net:		
Accounts receivable	$ 38,183	$ 39,011
Less allowance for doubtful accounts	(664)	(410)
Total	$ 37,519	$ 38,601
Inventories:		
Raw materials	$ 27,160	$ 15,392
Work in process	1,657	1,318
Finished goods	17,980	14,859
Total	$ 46,797	$ 31,569
Other assets:		
Cash surrender value of life insurance policies	$ 3,500	$ 2,834
Non-current deferred tax assets	2,176	1,507
Capitalized financing costs, net	1,841	2,114
Prepaid pension cost	1,242	—
Assets held for sale	583	583
Other	311	287
Total	$ 9,653	$ 7,325
Property, plant and equipment, net:		
Land and land improvements	$ 5,345	$ 4,992
Buildings	28,473	27,460
Machinery and equipment	60,090	55,794
Construction in progress	18,013	6,399
	111,921	94,645
Less accumulated depreciation	(56,704)	(53,675)
Total	$ 55,217	$ 40,970
Accrued expenses:		
Salaries, wages and related expenses	$ 4,084	$ 4,181
Income taxes	2,805	382
Customer rebates	758	1,003
Property taxes	641	456
Cash dividends	543	565
Sales allowance reserve	236	80
Worker's compensation	119	375
Pension	—	1,764
Other	633	477
Total	$ 9,819	$ 9,283

(15) RIGHTS AGREEMENT

On April 26, 1999, the Company's Board of Directors adopted a Rights Agreement and declared a dividend distribution of one right per share of the Company's common stock to shareholders of record as of May 17, 1999. In addition, the Rights Agreement provides that one right will attach to each share of the Company's common stock issued after May 17, 1999 until the tenth business day following a public announcement that a person or group has acquired, obtained the right to acquire or made a tender or exchange offer for 20% or more of the outstanding shares of the Company's common stock (such tenth business day, the "Distribution Date").

Currently, the rights are not exercisable but trade automatically with the Company's common stock shares. The rights become exercisable on the Distribution Date. Each right will entitle the holder, other than the acquiring person or group, to purchase one one-hundredth of a share (a "Unit") of the Company's Series A Junior Participating Preferred Stock at a purchase price of $80 per Unit, subject to adjustment as described in the Rights Agreement (the "Purchase Price"). All rights beneficially owned or acquired by the acquiring person or group will become null and void as of the Distribution Date. If an acquiring person or group acquires 20% or more of the Company's outstanding common stock, each rights holder, other than the acquiring person or group, upon exercise of his or her rights and payment of the Purchase Price, will severally have the right to receive shares of the Company's common stock having a value equal to two times the Purchase Price or, at the discretion of the Board of Directors, upon exercise and without payment of the Purchase Price, will have the right to purchase the number of shares of the Company's common stock having a value equal to two times the Purchase Price at a 50% discount.

In addition, each rights holder, other than an acquiring person or group, upon exercise of his or her rights will have the right to receive shares of the common stock of the acquiring corporation having a value equal to two times the Purchase Price for such holder's rights if the Company engages in a merger or other business combination where it is not the surviving entity or where it is the surviving entity and all or part of the Company's common stock is exchanged for the stock or other securities of the other company, or if 50% or more of the Company's assets or earning power is sold or transferred.

The rights will expire on April 26, 2009, and may be redeemed by the Company at any time prior to the Distribution Date at a price of $0.01 per right.

(16) PRODUCT WARRANTIES

The Company's products are used in applications which are subject to inherent risks including performance deficiencies, personal injury, property damage, environmental contamination or loss of production. The Company warrants its products to meet certain specifications and actual or claimed deficiencies from these specifications may give rise to claims. The Company does not maintain a reserve for warranties as the historical claims have been immaterial. The Company maintains product liability insurance coverage to minimize its exposure to such risks.

FINANCIAL INFORMATION BY QUARTER (UNAUDITED)

	Quarter Ended			
(In thousands, except for per share and price data)	December 31	April 1	July 1	September 30
2006				
Operating results:				
Net sales	$75,604	$79,776	$91,644	$82,483)
Gross profit	17,113	16,979	18,486	18,293
Earnings from continuing operations	8,013	7,845	9,066	9,453
Earnings (loss) from discontinued operations	(335)	(444)	(1,184)	626
Net earnings	7,678	7,401	7,882	10,079
Per share data:				
Basic:				
Earnings from continuing operations	0.43	0.43	0.50	0.52
Earnings (loss) from discontinued operations	(0.02)	(0.02)	(0.07)	0.04
Net earnings	0.41	0.41	0.43	0.56
Diluted:				
Earnings from continuing operations	0.42	0.42	0.50	0.52
Earnings (loss) from discontinued operations	(0.02)	(0.02)	(0.07)	0.03
Net earnings	0.40	0.40	0.43	0.55
Stock prices[(1)]				
High	8.68	29.70	30.00	24.85
Low	6.89	8.13	18.77	16.33
Cash dividends declared	0.03	0.03	0.03	0.03

	Quarter Ended			
	January 1	April 2	July 2	October 1
2005				
Operating results:				
Net sales	$65,063	$72,015	$85,646	$86,596
Gross profit	13,157	11,589	17,952	15,200
Earnings from continuing operations	5,059	4,425	8,600	6,415
Earnings (loss) from discontinued operations	57	619	(101)	(29)
Net earnings	5,116	5,044	8,499	6,386
Per share data:				
Basic:				
Earnings from continuing operations	0.28	0.24	0.46	0.34
Earnings (loss) from discontinued operations	—	0.03	(0.01)	—
Net earnings	0.28	0.27	0.45	0.34
Diluted:				
Earnings from continuing operations	0.27	0.23	0.45	0.34
Earnings (loss) from discontinued operations	—	0.03	(0.01)	—
Net earnings	0.27	0.26	0.44	0.34
Stock prices[(1)]				
High	10.95	9.99	7.62	8.63
Low	6.16	6.88	4.07	5.80
Cash dividends declared	—	—	0.03	0.03

(1) Prices adjusted to reflect 2-for-1 stock split on June 16, 2006.

SELECTED FINANCIAL DATA—FIVE-YEAR HISTORY

(In thousands, except for per share amounts)	Year Ended (52 weeks) September 30, 2006	(52 weeks) October 1, 2005	(53 weeks) October 2, 2004	(52 weeks) September 27, 2003	(52 weeks) September 28, 2002
Operating Results:					
Net sales	$329,507	$309,320	$298,754	$184,868	$194,201
Gross profit	70,871	57,898	78,956	19,632	23,505
Selling, general and administrative expense	16,996	16,175	21,194	11,165	10,718
Interest expense	669	3,427	5,832	4,126	3,596
Restructuring charges	—	—	—	—	2,839
Earnings (loss) from continuing operations before accounting change	34,377	24,499	32,035	9,512	(4,022)
Earnings (loss) from discontinued operations	(1,337)	546	(546)	(2,790)	(11,162)
Cumulative effect of accounting change	—	—	—	—	(10,538)
Net earnings (loss)	33,040	25,045	31,489	6,722	(25,722)
Per Share Data:					
Basic:					
Earnings (loss) from continuing operations before accounting change	$ 1.88	$ 1.31	$ 1.85	$ 0.56	$ (0.24)
Earnings (loss) from discontinued operations	(0.08)	0.03	(0.03)	(0.16)	(0.66)
Cumulative effect of accounting change	—	—	—	—	(0.62)
Net earnings (loss)	1.80	1.34	1.82	0.40	(1.52)
Diluted:					
Earnings (loss) from continuing operations before accounting change	1.86	1.29	1.78	0.55	(0.24)
Earnings (loss) from discontinued operations	(0.07)	0.03	(0.03)	(0.16)	(0.66)
Cumulative effect of accounting change	—	—	—	—	(0.62)
Net earnings (loss)	1.79	1.32	1.75	0.39	(1.52)
Cash dividends declared	0.12	0.06	—	—	—
Financial Position:					
Working capital	$ 56,938	$ 51,662	$ 61,253	$ 41,354	$ 32,421
Property, plant and equipment, net	55,217	40,970	38,897	40,201	43,809
Total assets	166,596	138,276	151,291	132,930	136,388
Total long-term debt	—	11,860	52,368	69,453	72,520
Shareholders' equity	122,438	97,036	71,211	31,272	23,324
Cash Flows:					
Net cash provided by operating activities	$ 44,835	$ 44,460	$ 28,122	$ 5,290	$ 9,446
Capital expenditures	18,959	6,302	2,921	933	198
Depreciation and amortization	5,107	5,627	6,209	5,143	5,440
Other Data:					
Number of employees at year-end	621	655	669	677	669

CORPORATE INFORMATION

BOARD OF DIRECTORS

Louis E. Hannen[1]
Retired Senior Vice President
Wheat, First Securities, Inc.

Charles B. Newsome[2]
Executive Vice President
Johnson Concrete Company

Gary L. Pechota[1]
Retired Chairman, President and
Chief Executive Officer
Giant Cement Holding, Inc.

W. Allen Rogers II[1]
Principal
Ewing Capital Partners, LLC

William J. Shields[2]
Retired Chairman and
Chief Executive Officer
Co-Steel, Inc.

C. Richard Vaughn[2,3]
Chairman
John S. Clark Company, Inc.

Howard O. Woltz, Jr.[3]
Chairman of the Board
Insteel Industries, Inc.

H.O. Woltz III[3]
President and Chief Executive Officer
Insteel Industries, Inc.

(1) Member of the Audit Committee
(2) Member of the Executive Compensation Committee
(3) Member of the Executive Committee

EXECUTIVE OFFICERS

H.O. Woltz III
President and Chief Executive Officer

Michael C. Gazmarian
Chief Financial Officer and Treasurer

James F. Petelle
Vice President—Administration and Secretary

SHAREHOLDER INFORMATION

Corporate Headquarters
1373 Boggs Drive
Mount Airy, North Carolina 27030-2148
(336) 786-2141

Independent Public Accountants
Grant Thornton LLP
Greensboro, North Carolina

Annual Meeting
Insteel shareholders are invited to attend our annual meeting which will be held at 10:00 A.M. on Tuesday, February 13, 2007, at the Cross Creek Country Club, 845 Greenhill Road, Mount Airy, North Carolina.

Common Stock
The Common Stock of Insteel Industries, Inc. is traded on the NASDAQ Global Market under the symbol IIIN. At December 6, 2006, there were 1,142 shareholders of record.

Shareholder Services
For change of name, address, ownership of stock; to replace lost stock certificates; or to consolidate accounts, please contact:

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Trust Company
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Investor Relations
For information on the Company, additional copies of this report, Form 10-K, or other financial information, contact Michael C. Gazmarian, Chief Financial Officer and Treasurer, at the Company's headquarters. You may also visit the Investor Information section on the Company's Web site at www.investor.insteel.com

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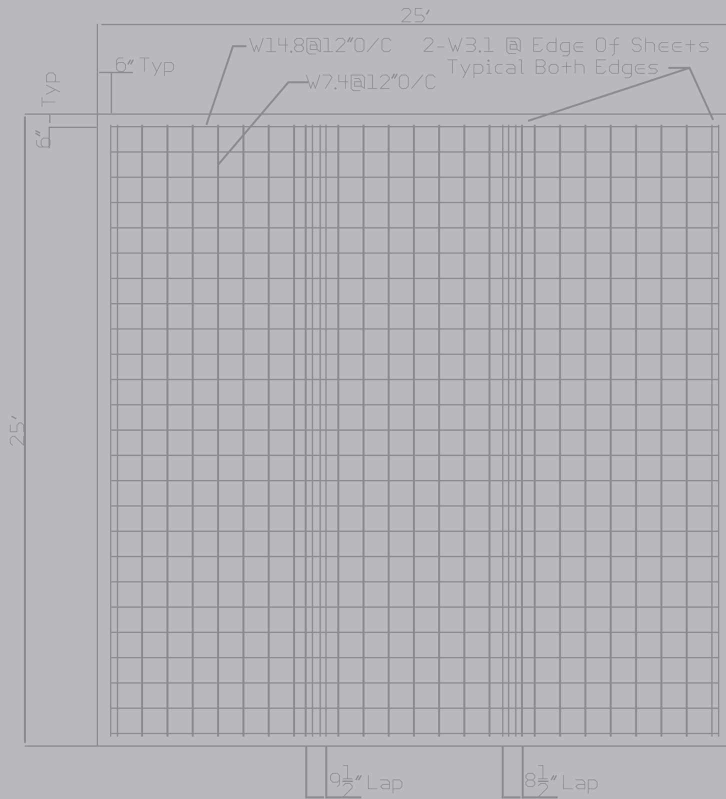

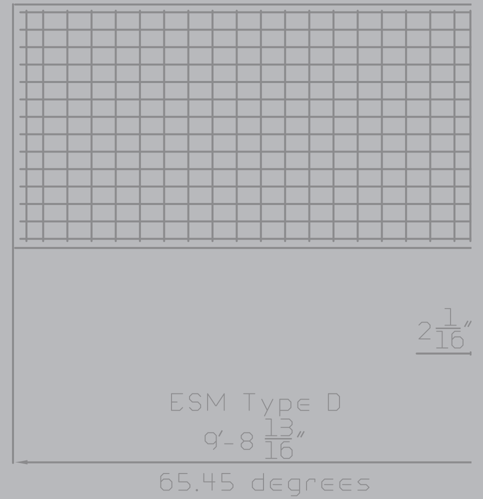

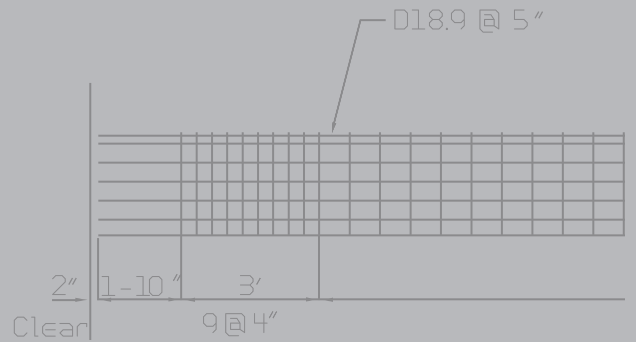

INSTEEL INDUSTRIES, INC.

1373 Boggs Drive, Mount Airy, North Carolina 27030-2148
phone (336) 786-2141
www.insteel.com

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