

Semco

INSTRUMENTS, INC.

*ANNUAL
REPORT
2006*

SEMCO INSTRUMENTS, INC. was founded in December 1965 as an engineering based aerospace manufacturer of temperature sensors. The product line has been expanded to include speed sensors, pressure sensors, electronic devices, coaxial heaters, and specialty electrical molded cables and wiring harnesses. These products serve the requirements of the gas turbine engine manufacturers, the aircraft manufacturers, and the satellite industry. The Company is registered to the ISO9001 and AS9100 quality standards and is focused on continuous process improvement in order to achieve world-class levels of quality, delivery, and customer support.

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To Our Shareholders:

Net sales achieved by your Company in 2006 were \$28,318,920 as compared to 2005 sales of \$24,448,701. Pre-tax income in 2006 was \$2,707,650 as compared to 2005 pre-tax income of \$788,466, and net income in 2006 was \$1,690,950 or \$0.39 per share as compared to a 2005 net income of \$489,466 or \$0.11 per share.

Sales increased 15.8% in 2006 reflecting a continued strong demand for our products. This growth in sales was largely driven by the robust demand from our OEM customers for legacy as well as newly qualified products. Sales to the U.S. Government experienced moderate growth in 2006 and we anticipate continued growth in future years as we would support the growing military aircraft and armored vehicle refurbishment programs. The balance between commercial and military sales was 65% / 35% and we are satisfied with this balance at this time as we continue to qualify products used on the newest commercial and military programs including the Boeing 787, the Airbus A380 and A400, several new business and regional jets, the latest Sikorsky helicopters and variants, as well as a number of industrial applications.

The level of profitability in 2006 was greatly improved as the Company experienced an increase in gross profit to 20.3% from 14.4% in 2005, an increase in pre-tax profit to 9.6% from 3.2% in 2005, and an increase in net profit to 6.0% from 2.0% in 2005. This increased level of profitability is the result of a multitude of continuous improvement efforts. In addition to eliminating non-contributing product, pursuing cost reductions from our supply chain, and continuing to seek improvement in all our processes, the Company continues to direct resources toward growing the production capacity of our manufacturing facility in Nogales, Mexico. In 2006 the Nogales facility grew from a start-up to production of over 3,000 units of diversified finished products and we are focused on continued growth of capacity in what will be a multi-year effort requiring extensive support from the Valencia facility. We are confident that the investment of resources in the Nogales facility will provide a platform to increase both our competitive position and profitability.

The Company is well positioned as a niche supplier to the aerospace industry and is taking the correct steps to meet the competitive challenges of this industry. We believe that we are postured to fully service customer requirements with engineering innovation, product quality, and the ability to consistently deliver our products and customer support in a just-in-time environment. This will be the basis of our continued growth.

I am thankful for your continued interest and support.



Michael G. Moore
President

Balance Sheets

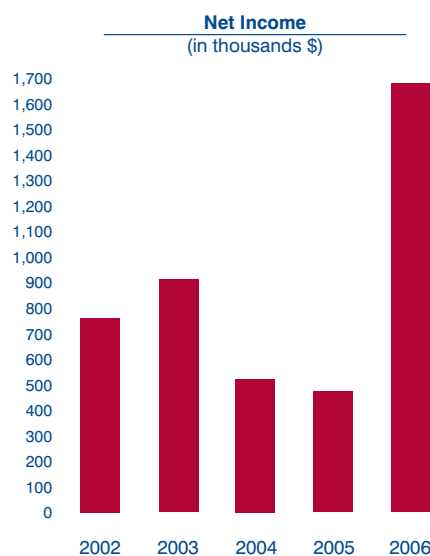
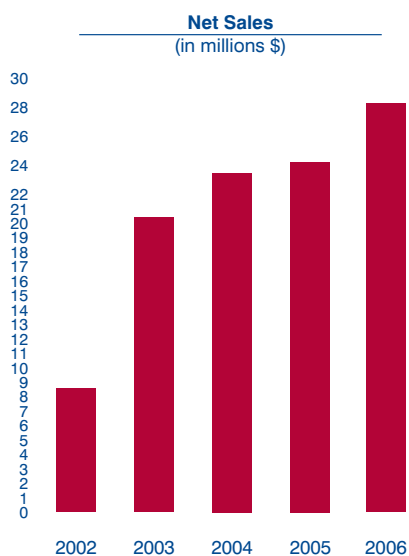
ASSETS	December 31	
	2006	2005
Current assets		
Cash and cash equivalents	\$ 144,324	\$ 142,708
Accounts receivable	3,793,896	3,295,562
Inventories	11,225,051	7,853,258
Prepaid expenses and other current assets	64,325	113,922
Deferred income taxes	557,000	310,000
Total current assets	15,784,596	11,715,450
Property, plant and equipment		
Land and improvements	980,356	980,356
Building and improvements	2,263,210	2,253,600
Machinery and equipment	2,325,322	2,239,761
Automotive equipment	153,095	153,095
Furniture, fixtures and computers	1,077,334	968,015
	6,799,317	6,594,827
Less accumulated depreciation and amortization	(4,190,510)	(3,816,893)
	2,608,807	2,777,934
Intangible and other assets	17,515	25,434
	\$18,410,918	\$14,518,818
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Line of credit	\$ 3,000,000	\$ 1,400,000
Current maturities of long-term debt	132,483	122,937
Accounts payable and accrued expenses	2,804,903	2,096,819
Income taxes payable	155,000	111,220
Total current liabilities	6,092,386	3,730,976
Non-current liabilities		
Long-term debt, less current maturities	3,252,002	3,384,485
Deferred compensation payable	28,889	21,666
Deferred income taxes	198,000	252,000
Total noncurrent liabilities	3,478,891	3,658,151
Commitments (Note 9)		
Stockholders' equity		
Common stock, \$0.01 par value; 6,000,000 shares authorized, 4,463,954 shares issued and outstanding	44,639	44,639
Additional paid-in capital	827,332	808,332
Retained earnings	7,984,724	6,293,774
	8,856,695	7,146,745
Less treasury stock, at cost, 86,625 shares	(17,054)	(17,054)
Total stockholders' equity	8,839,641	7,129,691
	\$18,410,918	\$14,518,818

See Notes to Financial Statements.

Statements of Income

	Years Ended December 31		
	2006	2005	2004
Net sales	\$28,318,920	\$24,448,701	\$23,772,804
Cost of sales	22,565,033	20,924,142	20,132,608
Gross profit	5,753,887	3,524,559	3,640,196
Selling, general and administrative expenses	2,712,465	2,386,992	2,497,970
income from operations	3,041,422	1,137,567	1,142,226
Other income (expense):			
Interest expense	(400,841)	(346,791)	(346,081)
Interest income	10,083	2,252	1,291
Other	56,986	(4,562)	993
	(333,772)	(349,101)	(343,797)
Income before provision for income taxes	2,707,650	788,466	798,429
Provision for income taxes	1,016,700	299,000	264,000
Net income	\$ 1,690,950	\$ 489,466	\$ 534,429
Earnings per common share:			
Basic	\$ 0.39	\$ 0.11	\$ 0.12
Diluted	\$ 0.38	\$ 0.11	\$ 0.12
Weighted average number of common shares outstanding, basic	4,377,329	4,377,329	4,397,954
Weighted average number of common shares outstanding, diluted	4,424,060	4,389,760	4,412,100

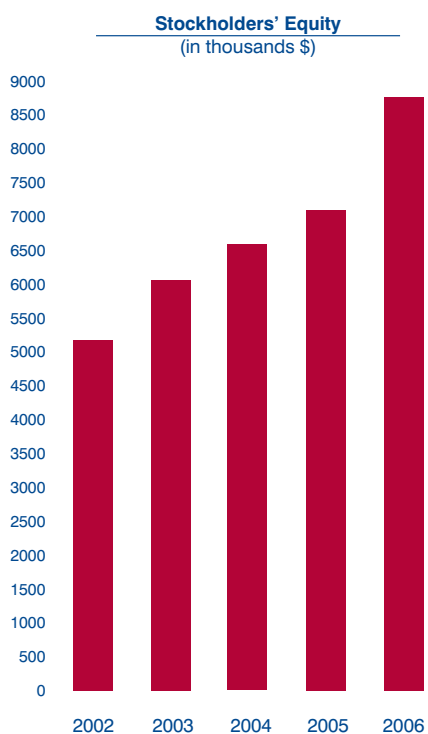
See Notes to Financial Statements.



Statements of Stockholders' Equity

	Common Stock		Additional Paid-in Capital	Retained Earnings	Treasury Stock, at Cost		Total
	Shares Outstanding	Amount			Shares	Amount	
Balance, December 31, 2003	4,525,829	45,258	869,588	5,269,879	86,625	(17,054)	6,167,671
Repurchase of common stock	-	-	-	-	61,875	(61,875)	(61,875)
Retirement of previously repurchased treasury stock	(61,875)	(619)	(61,256)	-	(61,875)	61,875	-
Net income	-	-	-	534,429	-	-	534,429
Balance, December 31, 2004	4,463,954	44,639	808,332	5,804,308	86,625	(17,054)	6,640,225
Net income	-	-	-	489,466	-	-	489,466
Balance, December 31, 2005	4,463,954	44,639	808,332	6,293,774	86,625	(17,054)	7,129,691
Net income	-	-	-	1,690,950	-	-	1,690,950
Stock-based compensation	-	-	19,000	-	-	-	19,000
Balance, December 31, 2006	4,463,954	\$ 44,639	\$ 827,332	\$ 7,984,724	86,625	\$ (17,054)	\$ 8,839,641

See Notes to Financial Statements.



Statements of Cash Flows

	Years Ended December 31		
	2006	2005	2004
Cash Flows from Operating Activities			
Net income	\$ 1,690,950	\$ 489,466	\$ 534,429
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation and amortization	381,536	432,639	448,632
Stock-based compensation	19,000	-	-
(Gain) loss on disposal of equipment	-	(2,710)	2,262
Deferred income taxes	(301,000)	(81,000)	(26,000)
Changes in operating assets and liabilities			
(Increase) in accounts receivables	(498,334)	(125,587)	(333,676)
(Increase) decrease in inventories	(3,371,793)	183,712	(1,576,977)
Decrease in prepaid expenses and other current assets	49,597	51,865	257,513
Increase in income taxes payable	43,780	111,220	-
Increase in accounts payable and accrued expenses	715,307	332,660	204,492
Net cash provided by (used in) operating activities	(1,270,957)	1,392,265	(489,325)
Cash Flows from Investing Activities			
Purchase of equipment and improvements	(204,490)	(270,452)	(267,237)
Proceeds from sale of equipment	-	9,799	9,000
Net cash (used in) investing activities	(204,490)	(260,653)	(258,237)
Cash Flows from Financing Activities			
Net borrowings (repayments) on line of credit	1,600,000	(2,100,000)	900,000
Borrowings on long-term debt	-	2,650,000	-
Repayments on long-term debt	(122,937)	(1,748,412)	(106,889)
Repurchase of common stock	-	-	(61,875)
Net cash provided by (used in) financing activities	1,477,063	(1,198,412)	731,236
Net increase (decrease) in cash and cash equivalents	\$ 1,616	\$ (66,800)	\$ (16,326)
Cash and cash equivalents			
Beginning	142,708	209,508	225,834
Ending	\$ 144,324	\$ 142,708	\$ 209,508
Supplemental Disclosures of Cash Flow Information			
Interest paid	\$ 398,546	\$ 355,567	\$ 347,318
Income taxes paid	\$ 1,236,753	\$ 193,700	\$ 56,697

See Notes to Financial Statements.

Notes to Financial Statements

1 NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Business

Semco Instruments, Inc. (the Company) designs, manufactures and sells precision sensors for the measurement of temperature, pressure, and speed, as well as specialty electrical molded cables and wiring harnesses. These products are sold principally to original equipment manufacturers in aerospace and commercial industries primarily located in North America. During 2003, the Company acquired the operating assets of Atlas-Aero Corporation (Atlas). In 2005, the Company opened a new manufacturing facility in Nogales, Mexico.

Use of Estimates

The preparation of the financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities and the reported amounts of revenue and expenses. Actual results could differ from those estimates and could materially affect the reported amount of assets, liabilities and future operating results. Significant estimates and assumptions made by management are used for, but not limited to, inventory obsolescence reserves.

Cash and Cash Equivalents

The Company considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents. The Company maintains its cash in bank deposit accounts which, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts. The Company believes it is not exposed to any significant risk relative to its cash accounts.

Accounts Receivables and Concentrations of Credit Risk

The Company's customers are concentrated in the commercial and military aviation industries. Accounts receivables are carried at original invoice amount less allowances provided for sales returns and doubtful accounts. The Company performs periodic credit evaluations of its customers' financial condition and generally does not require collateral. Receivables are generally due in 30 days. An accounts receivable is considered to be past due if any portion of the receivable balance is outstanding for more than 60 days beyond terms. Management determines the allowance for doubtful accounts by identifying troubled accounts and by using historical experiences. Accounts receivable are written off when deemed uncollectible. Management has determined that no allowance for doubtful accounts was necessary at December 31, 2006 and 2005.

Inventories

Inventories are stated at the lower of weighted average cost or market. The Company periodically reviews the age and turnover of its inventories to determine whether any inventory has become obsolete or has declined in value, and records a charge to operations for known and anticipated inventory obsolescence.

Customer Concentrations

The Company derived 53% of its net sales from two customers during 2006. Individually, the two customers accounted for 35% and 18% of net sales. These two customers represented 39% of accounts receivable at December 31, 2006. The Company derived 66% of its net sales from three customers during 2005. Individually, the three customers accounted for 34%, 20% and 12% of net sales. These three customers represented 55% of accounts receivable at December 31, 2005. The Company derived 57% of its net sales from two customers during 2004. Individually, the two customers accounted for 29% and 28% of net sales.

NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Fair Value of Financial Instruments

The Company's financial instruments consist of cash, accounts receivable, accounts payable and debt. The values reported in the financial statements approximate fair value due to their short-term nature.

Property, Plant and Equipment

Property, plant and equipment are recorded at cost. The Company uses the straight-line depreciation and amortization method for financial reporting purposes. The estimated useful lives by classes of assets used in computing depreciation and amortization are as follows:

	<u>Years</u>
Building and improvements	30
Machinery and equipment	5 – 7
Automotive equipment	5
Furniture, fixtures and computers	7 – 10

Expenditures for maintenance and repairs are charged against operations. Renewals and betterments that materially extend the life of the asset are capitalized.

Intangible Asset

Intangible asset consisted of a customer list, which was amortized using the straight-line method over its estimated useful life of three years. This amount was fully amortized at December 31, 2006.

Impairment of Long-Lived Assets and Amortizable Intangible Assets

The Company periodically reviews its property, plant, and equipment whenever events or changes in circumstances indicate the carrying amount of such assets may not be recoverable. The estimated future net undiscounted cash flows are based upon, among other things, assumptions about expected future operating performance which may differ from actual cash flows. Long-lived assets evaluated for impairment are grouped with other assets to the lowest level for which identifiable cash flows are largely dependent on the cash flows of other groups of assets and liabilities. Should the sum of the expected future net cash flows be less than the carrying value, the Company would recognize an impairment loss at that date. An impairment loss would be measured by comparing the amount by which the carrying value exceeds the fair value (estimated discounted future cash flows) of the long-lived assets. For the years ended December 31, 2006, 2005 and 2004 management has determined that no impairment of long-lived assets exists.

Product Warranty

The Company offers warranties to its customers for a period of one to five years from the date of purchase. The Company's warranties require it to repair or replace defective parts or components during the warranty period at no cost to the customer. The Company records a liability for estimated costs that may be incurred under its warranties as part of accrued expenses. The costs are estimated based on historical experience and any specific warranty issues that have been identified. Although historical warranty costs have been within expectations and have not been significant, there can be no assurance that future warranty costs will not exceed historical amounts. The Company periodically assesses the adequacy of its recorded warranty liability and adjusts the balance as necessary.

NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Employee Stock Option Plans

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 123(R), Share-Based Payment. SFAS No. 123(R) requires that the compensation cost relating to share-based payment transactions, including grants of employee stock options, be recognized in financial statements. The compensation cost is measured based on the fair value of the equity or liability instruments issued. SFAS No. 123(R) permits entities to use any option-pricing model that meets the fair value objective in SFAS No. 123(R).

The Company adopted the provisions of SFAS No. 123(R), effective January 1, 2006, using the modified prospective method, which requires the recognition of expense over the remaining vesting period for the portion of the awards not fully vested as of December 31, 2006. Net stock-based compensation expense amounted to \$19,000 for the year ended December 31, 2006.

As a result of the adoption of SFAS No. 123(R) and based on the stock-based compensation awards outstanding as of December 31, 2006, the Company expects to recognize additional pre-tax compensation cost in future years as follows:

<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>Total</u>
<u>\$40,000</u>	<u>\$40,000</u>	<u>\$40,000</u>	<u>\$18,000</u>	<u>\$138,000</u>

The fair value of each option granted during 2006 was estimated at the grant date using the Black-Scholes option pricing method, with the following assumptions: estimated volatility of 22%, risk-free interest rate of 5.15%, the options would be exercised at the end of the exercise period and the Company would declare no dividends.

In determining pro forma net income, the fair value of each option granted was estimated at the grant date using the Black-Scholes option pricing method. The following assumptions were made for the options granted prior to 2002: estimated volatility of 21%, risk-free interest rate of 4.75%, the options would be exercised at the end of the exercise period and the Company would declare and pay no dividends. The following assumptions were made for the options granted in 2002: estimated volatility of 17%, risk-free interest rate of 4.25%, the options would be exercised at the end of the exercise period and the Company would declare no dividends. There were no options granted in 2005, 2004 and 2003.

The following table illustrates the effect on the Company's net income and earnings per share, had the Company applied the fair value recognition provision of SFAS 123(R) for the years ended December 31, 2005 and 2004:

	<u>2005</u>	<u>2004</u>
Net income		
As reported	\$ 489,466	\$ 534,429
Stock-based compensation expense determined under fair value method	2,367	2,367
Pro forma	<u>\$ 487,099</u>	<u>\$ 532,062</u>
Basic EPS:		
As reported	\$ 0.11	\$ 0.12
Pro forma	0.11	0.12
Diluted EPS:		
As reported	\$ 0.11	\$ 0.12
Pro forma	0.11	0.12

NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Revenue Recognition

Revenue is recognized as products are shipped and title and risk of loss have transferred to the customer.

Advertising Costs

The Company expenses all advertising costs as incurred.

Income Taxes

Deferred tax assets and liabilities are recognized for estimated future tax effects attributable to temporary differences between the book basis and tax basis of various assets and liabilities. Valuation allowances are established when necessary to reduce the deferred tax asset to the amount expected to be realized. The current and deferred taxes are based on the provisions of currently enacted tax laws and rates. As changes in tax laws are enacted, deferred tax assets and liabilities are adjusted accordingly through the provision for income taxes. Management has determined that no valuation allowance was necessary at December 31, 2006 and 2005.

Segment Information

The Company operates as one segment, designing, manufacturing and selling precision sensors for the measurement of temperature, pressure, and speed, as well as specialty electrical molded cables and wiring harnesses. For purposes of reporting and aggregating revenue to foreign countries, sales are attributed to the country of the headquarters of the customer. All major customers are headquartered in the United States.

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but applies under other existing accounting pronouncements that require or permit fair value measurements. SFAS No. 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement and, therefore, should be determined based on the assumptions that market participants would use in pricing that asset or liability. SFAS No. 157 also establishes a fair value hierarchy that distinguishes between market participant assumptions developed based on market data obtained from independent sources and the Company's own assumptions about market participant assumptions based on the best information available. SFAS No. 157 is effective starting January 1, 2008. The Company does not expect adoption of SFAS No. 157 to have any impact on the Company's financial statements.

In June 2006, the FASB issued FASB Interpretation No. 48 (FIN 48) Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109, which is effective for fiscal years beginning after December 15, 2006. This interpretation was issued to clarify the accounting for uncertainty in income taxes recognized in the financial statements by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Company does not expect adoption of FIN 48 to have any impact on the Company's financial statements.

Earnings Per Common Share

Basic EPS excludes dilution and is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for the year. Diluted EPS is based upon the weighted average number of common shares outstanding during the year plus the additional weighted average common equivalent shares during the year, if any. Common equivalent shares are not included in the diluted EPS calculations where the effect of their inclusion would be antidilutive. Common equivalent shares result from the assumed exercise of outstanding stock options, the proceeds of which are then assumed to have been used to repurchase outstanding stock using the treasury stock method.

NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

The following table sets forth the computation of the shares outstanding for basic and fully diluted EPS as of December 31:

	2006	2005	2004
Shares outstanding, basic EPS	4,377,329	4,377,329	4,397,952
Effect of dilutive securities, employee stock options	46,731	12,431	14,146
Shares outstanding, diluted EPS	<u>4,424,060</u>	<u>4,389,760</u>	<u>4,412,100</u>

Business Combination

In 2003 the Company acquired the operating assets and liabilities of Atlas for approximately \$5,798,000, consisting of \$4,798,000 cash paid (including \$329,000 of deal costs) and \$1,000,000 debt issued. The fair value of the intangible asset acquired was \$143,000 and was assigned to a customer list, which was amortized over three years. In connection with this acquisition, the Company issued a \$1,000,000 note payable to the former owner of Atlas (see Note 5).

2 INVENTORIES

Inventories consist of the following at December 31:

	2006	2005
Raw materials and fabricated parts	\$ 8,290,811	\$ 5,790,404
Work in process	1,667,401	1,216,251
Finished goods	1,636,839	1,074,603
	<u>11,595,051</u>	<u>8,081,258</u>
Less reserve for obsolete inventories	(370,000)	(228,000)
	<u>\$ 11,225,051</u>	<u>\$ 7,853,258</u>

3 LINE OF CREDIT

The Company has a revolving line of credit agreement with a bank for borrowings up to a maximum of \$4,000,000. The amounts outstanding under this agreement were \$3,000,000 and \$1,400,000 at December 31, 2006 and 2005, respectively. The agreement provides for interest, payable monthly, at the bank's prime rate (8.25% at December 31, 2006), with interest rate options based on LIBOR plus 2% (7.35% at December 31, 2006). At December 31, 2006, \$1,100,000 was outstanding at 8.25% and \$1,900,000 at 7.35%. Borrowings generally are limited to 80% of eligible accounts receivable and the lesser of 30% of raw materials plus 40% of finished goods, or \$1,750,000. The amount available for borrowing was approximately \$1,000,000 at December 31, 2006. The line of credit is collateralized by all assets of the Company, including accounts receivables, inventories, equipment and fixtures. The line of credit expires June 15, 2007.

The line of credit contains various covenants, including the maintenance of a certain minimum financial ratios related to tangible net worth, debt-to-tangible net worth, quick and cash flow ratios. In addition, the Company is subject to certain restrictions related to paying dividends, purchases of treasury stock and fixed assets. At December 31, 2006, the Company was in compliance with all the covenant requirements.

4 ACCOUNTS PAYABLE AND ACCRUED EXPENSES

Accounts payable and accrued expenses at December 31 consist of the following:

	<u>2006</u>	<u>2005</u>
Accounts payable	\$ 1,899,340	\$ 1,357,742
Compensation and related payroll taxes	772,765	616,102
Interest	26,354	24,059
Self-insurance liability	50,000	64,000
Other	56,444	34,916
	<u>\$ 2,804,903</u>	<u>\$ 2,096,819</u>

In 2005 the Company started sponsoring a self-insured group medical insurance plan. The plan is designed to provide a specified level of coverage, with stop-loss coverage provided by a commercial insurer. The Company's maximum claim exposure is limited to \$50,000 per person per policy year, with the total plan exposure capped at approximately \$650,000 per policy year. The plan provides contributory coverage for employees and their dependents. The Company's contributions totaled approximately \$461,000 and \$477,000 for the years ended December 31, 2006 and 2005. At December 31, 2006 and 2005, the Company recorded \$50,000 and \$64,000, respectively, of accruals based on the aggregate amount of the liability for reported claims and an estimated liability for claims incurred but not reported.

5 LONG-TERM DEBT

Long-term debt at December 31 is as follows:

	<u>2006</u>	<u>2005</u>
Note payable, bank, secured by first deed of trust on real estate, payable in monthly installments of \$3,597 plus interest at the bank's prime rate plus 0.5% maturing on October 1, 2015, subject to an interest rate swap agreement, which effectively fixed the interest rate at 6.49% (see Note 10).	\$ 2,599,159	\$ 2,642,807
Note payable, former owner of Atlas, subordinated to the bank's line of credit and second security interest in all assets of the Company, payable in monthly installments of \$12,133, including interest at 8.0%, maturing in December 2014.	785,326	864,615
	<u>3,384,485</u>	3,507,422
Less current maturities	<u>(132,483)</u>	<u>(122,937)</u>
	<u>\$ 3,252,002</u>	<u>\$ 3,384,485</u>

LONG-TERM DEBT (continued)

Aggregate maturities of long-term debt as of December 31, 2006 are as follows:

Year Ending December 31,	
2007	\$ 132,483
2008	142,776
2009	153,877
2010	165,848
2011	178,757
Thereafter	<u>2,610,744</u>
	<u>\$ 3,384,485</u>

6 INCOME TAXES

Allocation of income taxes between current and deferred portions for the years ended December 31 are as follows:

	<u>2006</u>	2005	2004
Current:			
Federal	\$ 1,069,857	\$ 310,978	\$ 229,555
State	247,843	69,022	60,445
	1,317,700	380,000	290,000
Deferred	(301,000)	(81,000)	(26,000)
	\$ 1,016,700	299,000	\$ 264,000

The following table presents a reconciliation of income tax determined by applying the U.S. federal income tax rate to pretax income:

	<u>2006</u>	2005	2004
Computed expected statutory rate	35%	35%	35%
Increase (decrease) in rate resulting from:			
State taxes, net of federal benefit	4	4	4
Other, principally benefit from reduced rate on foreign export sales	-	(1)	(6)
	39%	38%	33%

Net deferred income tax assets (liabilities) as of December 31 consist of the following components:

	<u>2006</u>	2005
Deferred tax liabilities:		
Depreciation and amortization	\$ (98,000)	\$ (118,000)
Undistributed DISC income	(134,000)	(168,000)
	(232,000)	(286,000)
Deferred tax assets:		
Inventory reserve and capitalization	324,000	184,000
Accrued compensation	194,000	142,000
Other	73,000	18,000
	591,000	344,000
	\$ 359,000	\$ 58,000

INCOME TAXES (continued)

Net deferred income tax assets (liabilities) have been included in the accompanying balance sheets at December 31 as follows:

	2006	2005
Current assets	\$ 557,000	\$ 310,000
Long-term liabilities	(198,000)	(252,000)
	<u>\$ 359,000</u>	<u>\$ 58,000</u>

During 2001 the Company revoked its election pertaining to the maintenance of its Domestic International Sales Corporation (DISC). As a result of terminating the DISC, the Company is required to pay federal tax on undistributed DISC income of approximately \$800,000, or approximately \$34,000 per year, through 2010. A deferred income tax liability has been provided for all of the undistributed DISC income.

7 STOCK OPTION PLANS

The Company has two stock option plans covering the Company's common shares. Nonqualified stock options may be issued to officers, directors or key employees of the Company under both plans. Qualified stock options may be issued to employees of the Company under both plans. Qualified and nonqualified stock options are exercisable at prices not less than the fair market value on the date of grant (not less than 110% of the fair market value for participating individuals who own more than 10% of the outstanding voting stock of the Company).

Options granted under the Company's stock option plans generally are exercisable beginning one year from the date of grant and vest at the rate of 25% per year on a cumulative basis. The options expire at the earlier of 5 to 10 years from the date of grant or one month from the stock option holder's termination of employment.

A summary of stock option activity during the years ended December 31 is as follows:

	2006		2005		2004	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year:	150,000	\$0.84	150,000	\$ 0.84	150,000	\$ 0.84
Granted	600,000	1.13	-	-	-	-
Canceled	-	-	-	-	-	-
Exercised-	-	-	-	-	-	-
Outstanding at end of year	<u>750,000</u>	1.07	<u>150,000</u>	0.84	<u>150,000</u>	0.84
Options exercisable, end of year	<u>150,000</u>	0.84	<u>112,000</u>	0.84	<u>75,000</u>	0.84
Options available for grant, end of year	<u>-</u>		<u>600,000</u>		<u>600,000</u>	

STOCK OPTION PLANS (continued)

The following table summarizes information about stock options outstanding at December 31, 2006:

Exercise Price	Number Outstanding	Remaining Contractual Life (in Years)	Number Exercisable
\$ 0.90	34,000	1	34,000
0.82	116,000	1	116,000
1.55	460,000	9.5	-
1.05	140,000	9.5	-
	<u>750,000</u>		<u>150,000</u>

8 EMPLOYEE BENEFIT PLANS

Retirement plan

The Company has a 401(k) profit sharing plan for full-time employees who have completed 3 months of service and reached age 21. Eligible employees may contribute to the 401(k) plan up to 90% of their wages up to the allowable Internal Revenue Service limit. The plan allows for Company discretionary matching contributions. The Company has not made any discretionary matching or profit sharing contributions to the plan during the years ended December 31, 2006, 2005 and 2004.

Deferred Compensation Agreement

The Company has established nonqualified deferred compensation agreements for four key employees. The agreements provide for a total benefit of \$65,000. The benefit under these agreements vests at the earlier of the participant's death or retirement at age 65, or the later of nine years of employee service or the employee's voluntary termination thereafter. At December 31, 2006 and 2005, the accrued liability related to these agreements amounted to \$28,889 and \$21,666, respectively. Deferred compensation expense amounted to approximately \$7,300 for each of the years ended December 31, 2006, 2005 and 2004.

9 LEASE COMMITMENT

In 2005, the Company entered into a four-year non-cancelable operating lease agreement expiring September 2009 for one of its manufacturing facilities, with monthly lease payments of approximately \$9,800. The following is a schedule of future minimum rental payments:

Year Ending December 31,	
2007	\$ 117,600
2008	117,600
2009	88,200
	<u>\$ 323,400</u>

Rent expense was approximately \$224,000 and \$140,000 for the years ended December 31, 2006 and 2005, respectively.

10 INTEREST RATE SWAP

As disclosed in Note 5, the Company entered into an interest rate swap agreement with the bank that effectively fixed the \$2,650,000 note payable at a rate of 6.49% until October 2015. The cumulative gain or loss from changes in the swap agreement's fair value will be included in other comprehensive income and will be reclassified into income or interest expense if the note is repaid at an earlier date than the full term. As of December 31, 2006 and 2005, this amount was immaterial and not recorded in other comprehensive income.

Independent Auditors' Report

To the Board of Directors
Semco Instruments, Inc.
Valencia, California

We have audited the accompanying balance sheets of Semco Instruments, Inc. as of December 31, 2006 and 2005 and the related statements of income, stockholders' equity and cash flows for the years then ended. 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. The financial statements of Semco Instruments, Inc. as of and for the year ended December 31, 2004 were audited by other auditors, whose report dated April 8, 2005 expressed an unqualified opinion on those statements.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits 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 2006 and 2005 financial statements referred to above present fairly, in all material respects, the financial position of Semco Instruments, Inc. as of December 31, 2006 and 2005, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Hutchinson and Bloodgood LLP

Glendale, California
March 24, 2007

Financial Highlights

FIVE YEAR SUMMARY	2006	2005	2004	2003	2002
Income Statement Data					
Net income	\$ 1,690,950	\$ 489,466	\$ 534,429	\$ 921,986	\$ 730,687
Return on sales	6.0%	2.0%	2.2%	4.5%	8.3%
Earnings per share	0.39	0.11	0.12	0.21	0.17
Weighted average # of shares outstanding	4,377,329	4,377,329	4,397,954	4,339,482	4,339,204
Net sales	28,318,920	24,448,701	23,772,804	20,342,240	8,850,951
Cost of sales	22,565,033	20,924,142	20,132,608	16,486,998	6,272,577
Gross profit margin	20.3%	14.4%	15.3%	19.0%	29.1%
Selling, general & administrative expense	2,712,465	2,386,992	2,497,970	2,159,137	1,320,634
Selling, general & administrative % of sales	9.6%	9.8%	10.5%	10.6%	14.9%
Interest expense, net	390,758	344,539	344,790	277,819	107,837
EBITDA	3,479,944	1,565,644	1,591,851	2,066,492	1,494,884
EBITDA margin	12.3%	6.4%	6.7%	10.2%	16.9%
Working Capital					
Quick ratio	0.6	0.9	0.5	0.7	3.3
Current ratio	2.6	3.1	1.7	2.4	6.2
Days sales in receivables	49	49	49	51	65
Working capital as % of sales	34.2%	32.6%	20.5%	29.4%	51.0%
Inventory turnover	2.4	2.6	2.8	3.8	2.8
Leverage and Other					
Asset turnover	1.72	1.67	1.68	1.88	1.10
Stockholder's equity	8,839,641	7,129,691	6,640,225	6,167,671	5,208,723
Return on stockholders' equity	19.1%	6.9%	8.0%	14.9%	14.0%
Liabilities and Debt/Equity	1.1	1.0	1.2	1.2	0.6
Liabilities and Debt/Assets	0.5	0.5	0.6	0.5	0.4

DIRECTORS

M. S. Moore
Chairman/CEO
Semco Instruments, Inc.

Michael G. Moore
President
Semco Instruments, Inc.

Arnold Twersky
Certified Public Accountant
Northridge, California

Daniel C. de Brauwere
President
Pacific/Southwest Division
Business Capital
Bank of America
Pasadena, California

Samuel J. Moore
Sales Manager
Semco Instruments, Inc.

OFFICERS

M.S. Moore – CEO
Michael G. Moore – President
Samuel J. Moore – Secretary/Treasurer

COUNSEL

Holland & Knight, LLP
Los Angeles, California

AUDITORS

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Glendale, California

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