

Semco

INSTRUMENTS, INC.

***ANNUAL
REPORT
2008***

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.

TABLE OF CONTENTS

Letter to Shareholders	Page 1
Financial Statements	
Balance Sheets	2
Statements of Income	3
Statements of Stockholders' Equity	4
Statements of Cash Flows	5
Notes to Financial Statements	6-14
Independent Auditors' Report	15
Financial Highlights	16
Financial Highlights	16

To Our Shareholders:

Net sales achieved by your Company in 2008 were \$33,291,842 as compared to 2007 sales of \$34,201,540. Pre-tax income in 2008 was \$3,396,342 in 2008 as compared to 2007 pre-tax income of \$3,794,659, and net income was \$2,156,166 or \$0.47 per share in 2008 as compared to a 2007 net income of \$2,416,542 or \$0.55 per share.

While sales in 2008 declined 2.7% over the 2007 level, demand remained strong from the OEM, military, industrial, and repair station customers. The reduction in sales was attributable to briefly reduced production capacity after closing the Meriden, Connecticut facility in the 2nd quarter of 2008; this capacity was replaced through continued growth in production capacity in the Nogales, Mexico facility. Notwithstanding the short-lived gap in production capacity, the Company had available backlog and materials to support a sales level in 2008 that would have exceeded 2007 levels. Backlog at the end of 2008 was at an all time high and the balance between commercial and military requirements was approximately 60% / 40% in 2008.

The level of net profitability declined 0.6% in 2008, still achieving a 6.5% return on sales as compared to 7.1% in 2007. Gross profit in 2008 was 20.8% as compared to 21.5% in 2007 and the pre-tax profit in 2008 was at a 10.2% level as compared to 11.1% in 2007. The slight decline in profitability was the result of one-time costs associated with the closing of the facility in Meriden, Connecticut, transition of manufacturing, as well as the margin mix of product shipped in 2008. Improved profitability is anticipated for 2009 as the Company continues to pursue process improvements and shifts manufacturing to our facility in Nogales, Mexico.

There is much uncertainty in the economy and the Company is taking the correct steps to remain lean and competitive within the aerospace and industrial markets. The Company is well positioned as a niche supplier and is 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.

M.S. Moore, the CEO and Chairman of the Board of the Company, passed away on November 28, 2008. Sam Moore founded Semco Instruments in 1965, arranged for the Company to become public in 1972, and was instrumental in the diversification of the Company's product line and business growth. He was and will continue to be an inspiration to all who had the privilege of working with him.

I am thankful to our shareholders for your continued interest and support, to our customers for choosing Semco Instruments as their supplier, and to our employees for their dedication and hard work.



Michael G. Moore
President

Balance Sheets

ASSETS

	December 31	
	2008	2007
Current assets		
Cash and cash equivalents	\$ 167,050	\$ 149,377
Accounts receivable	4,564,679	4,383,295
Inventories	14,595,986	13,110,430
Prepaid expenses and other current assets	393,067	235,953
Deferred income taxes	783,000	764,000
Total current assets	20,503,782	18,643,055
Property, plant and equipment		
Land and improvements	980,356	980,356
Building and improvements	2,340,112	2,270,770
Machinery and equipment	2,433,325	2,395,744
Automotive equipment	137,241	224,812
Furniture, fixtures and computers	1,042,485	1,049,829
	6,933,519	6,921,511
Less accumulated depreciation and amortization	(4,494,816)	(4,366,588)
	2,438,703	2,554,923
Deposits	17,515	17,515
	\$22,960,000	\$21,215,493

LIABILITIES AND STOCKHOLDERS' EQUITY

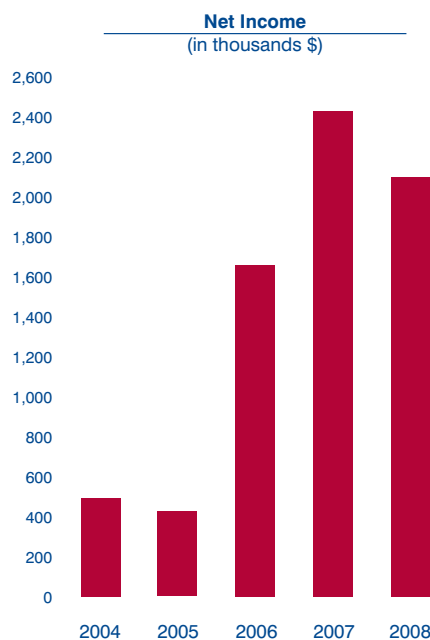
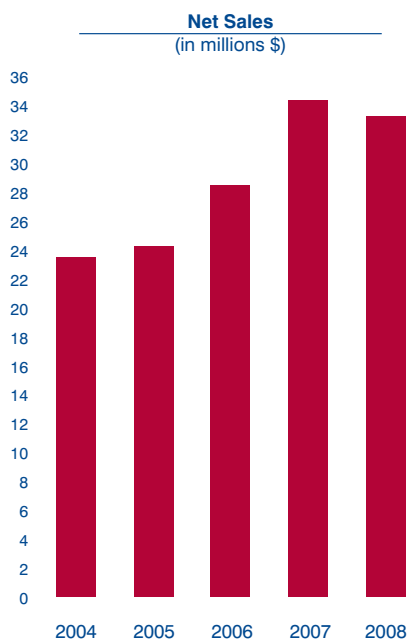
Current liabilities		
Line of credit	\$ 2,300,000	\$ –
Current maturities of long-term debt	153,877	142,776
Accounts payable and accrued expenses	3,687,061	3,278,262
Total current liabilities	6,140,938	3,421,038
Noncurrent liabilities		
Line of credit	–	3,000,000
Long-term debt, less current maturities	2,955,349	3,109,226
Deferred compensation payable	68,353	44,660
Deferred income taxes	2,000	184,000
Obligation under interest rate swap	366,000	–
Total noncurrent liabilities	3,391,702	6,337,886
Commitment and Contingencies (Note 3 and 9)		
Stockholders' equity		
Common stock, \$0.01 par value; 6,000,000 shares authorized, 4,649,204 (2008) and 4,626,954 (2007) shares issued and outstanding	46,492	46,269
Additional paid-in-capital	1,071,490	1,026,088
Accumulated other comprehensive loss	(231,000)	–
Retained earnings	12,557,432	10,401,266
	13,444,414	11,473,623
Less treasury stock, at cost, 86,625 shares	(17,054)	(17,054)
Total stockholders' equity	13,427,360	11,456,569
	\$22,960,000	\$21,215,493

The Notes to Financial Statements are an integral part of these statements.

Statements of Income

	Years Ended December 31		
	2008	2007	2006
Net sales	\$33,291,842	\$34,201,540	\$28,318,920
Cost of sales	26,382,830	26,860,362	22,565,033
Gross profit	6,909,012	7,341,178	5,753,887
Selling, general and administrative expenses	3,015,932	3,123,640	2,712,465
income from operations	3,893,080	4,217,538	3,041,422
Other income (expense):			
Interest expense	(330,827)	(444,616)	(400,841)
Interest income	5,359	15,811	10,083
Other	(171,270)	5,926	56,986
	(496,738)	(422,879)	(333,772)
Income before provision for income taxes	3,396,342	3,794,659	2,707,650
Provision for income taxes	1,240,176	1,378,117	1,016,700
Net income	\$ 2,156,166	\$ 2,416,542	\$ 1,690,950
Earnings per common share:			
Basic	\$ 0.47	\$ 0.55	\$ 0.39
Diluted	\$ 0.44	\$ 0.54	\$ 0.38
Weighted average number of common shares outstanding, basic	4,550,539	4,421,437	4,377,329
Weighted average number of common shares outstanding, diluted	4,871,898	4,474,817	4,424,060

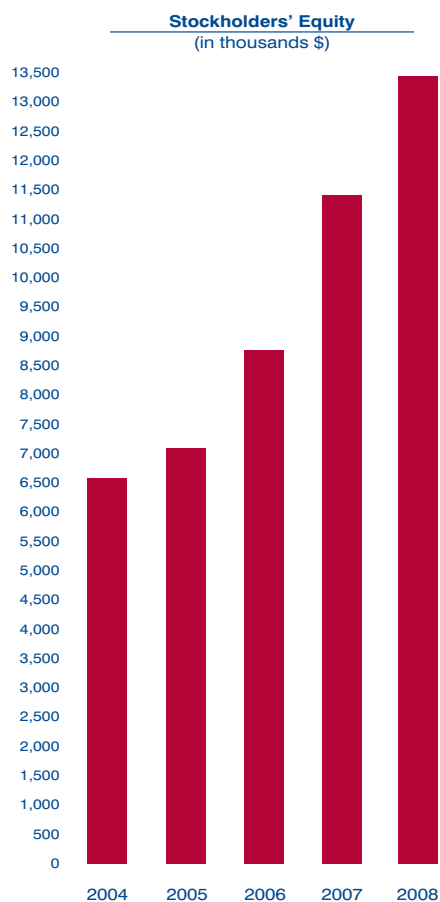
The Notes to Financial Statements are an integral part of these statements.



Statements of Stockholders' Equity

	Common Stock		Additional Paid-in Capital	Accumulated Other Comprehensive Loss	Retained Earnings	Treasury Stock, at Cost		Total
	Outstanding Shares	Amount				Shares	Amount	
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
Net income	–	–	–	–	2,416,542	–	–	2,416,542
Exercise of Stock Options	163,000	1,630	155,756	–	–	–	–	157,386
Stock-based compensation	–	–	43,000	–	–	–	–	43,000
Balance, December 31, 2007	4,626,954	46,269	1,026,088	–	10,401,266	86,625	(17,054)	\$11,456,569
Net income	–	–	–	–	2,156,166	–	–	2,156,166
Change in fair value of interest rate swap contract, net of tax	–	–	–	(231,000)	–	–	–	(231,000)
Shares reacquired and canceled	(5,250)	(52)	(26,198)	–	–	–	–	(26,250)
Exercise of Stock Options	27,500	275	28,600	–	–	–	–	28,875
Stock-based compensation	–	–	43,000	–	–	–	–	43,000
Balance, December 31, 2008	4,649,204	\$ 46,492	\$ 1,071,490	(231,000)	\$12,557,432	86,625	\$ (17,054)	\$13,427,360

The Notes to Financial Statements are an integral part of these statements.



Statements of Cash Flows

	Years Ended December 31		
	2008	2007	2006
Cash Flows from Operating Activities			
Net income	\$ 2,156,166	\$ 2,416,542	\$ 1,690,950
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation and amortization	317,321	341,233	381,536
Stock-based compensation	43,000	43,000	19,000
Gain on disposal of equipment	3,366	(33,500)	-
Deferred income taxes	(66,000)	(221,000)	(301,000)
Changes in operating assets and liabilities			
Increase in accounts receivables	(181,384)	(589,399)	(498,334)
Increase in inventories	(1,485,556)	(1,885,379)	(3,371,793)
Decrease (increase) in prepaid expenses and other current assets	(157,114)	(171,628)	49,597
Increase (decrease) in income taxes payable	-	(155,000)	43,780
Increase in accounts payable and accrued expenses	432,492	489,130	715,307
Net cash provided by (used in) operating activities	1,062,291	233,999	(1,270,957)
Cash Flows from Investing Activities			
Purchase of equipment and improvements	(246,800)	(297,824)	(204,490)
Proceeds from sale of equipment	42,333	43,975	-
Net cash used in investing activities	(204,467)	(253,849)	(204,490)
Cash Flows from Financing Activities			
Net borrowings (repayments) on line of credit	(700,000)	-	1,600,000
Repayments on long-term debt	(142,776)	(132,483)	(122,937)
Net proceeds from exercise of stock options	2,625	157,386	-
Net cash provided by (used in) financing activities	(840,151)	24,903	1,477,063
Net increase (decrease) in cash and cash equivalents	\$ 17,673	\$ 5,053	\$ 1,616
Cash and cash equivalents			
Beginning	149,377	144,324	142,708
Ending	<u>\$ 167,050</u>	<u>\$ 149,377</u>	<u>\$ 144,324</u>
Supplemental Disclosures of Cash Flow Information			
Interest paid	<u>\$ 324,897</u>	<u>\$ 446,648</u>	<u>\$ 398,546</u>
Income taxes paid	<u>\$ 1,466,000</u>	<u>\$ 1,639,000</u>	<u>\$ 1,236,753</u>
Supplemental Disclosures of Non Cash Investing and Financing Activities			
Interest rate swap contract loss:			
Deferred income tax benefit of unrealized loss on swap contract	\$ 135,000	\$ -	\$ -
Obligation under interest rate swap	\$ (366,000)	\$ -	\$ -
Change in fair value of interest rate swap contract	\$ 231,000	\$ -	\$ -

The Notes to Financial Statements are an integral part of these 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.

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, 2008 and 2007.

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 62% of its net sales from three customers during 2008. Individually, the three customers accounted for 34%, 15% and 13% of net sales. These three customers represented 57% of accounts receivable at December 31, 2008. The Company derived 54% of its net sales from two customers during 2007. Individually, the two customers accounted for 32% and 22% of net sales. These two customers represented 46% of accounts receivable at December 31, 2007. 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.

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.

Impairment of Long-Lived 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 of the long-lived assets. For the years ended December 31, 2008, 2007 and 2006 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.

Employee Stock Option Plans

At December 31, 2008, The Company has a stock option plan covering the Company's common shares, which is described more fully in Note 7. The Company adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 123(R), effective January 1, 2006, using the modified prospective method, and began recording compensation expense associated with stock-based awards. SFAS 123(R) requires all share-based payments to be recognized as compensation expense through the income statement based on their fair value at issue date over the remaining vesting period. Pre-tax stock-based compensation expense amounted to \$43,000, \$43,000 and \$19,000 for the years ended December 31, 2008, 2007 and 2006, respectively.

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

Employee Stock Option Plans (Continued)

As a result of the adoption of SFAS No. 123(R) and based on the stock-based compensation awards outstanding as of December 31, 2008, the Company expects to recognize additional pre-tax compensation cost in future years as follows:

2009	2010	Total
\$43,000	\$20,000	\$63,000

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 22.00%, 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. No options were granted during 2008 and 2007.

Swap Agreement

The Company uses an interest rate swap contract designed to hedge the risk of changes in interest payments on its note with a bank caused by changes in LIBOR (see Note 10).

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, 2008 and 2007.

In June 2006, the Financial Accounting Standards Board (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 adoption of FIN 48 during the year ended December 31, 2007 did not have an impact on the Company's financial statements.

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

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 dilutive 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.

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

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Shares outstanding, basic EPS	4,550,539	4,421,437	4,377,329
Effect of dilutive securities, employee stock options	321,359	53,380	46,731
Shares outstanding, diluted EPS	<u>4,871,898</u>	<u>4,474,817</u>	<u>4,424,060</u>

2 INVENTORIES

Inventories consist of the following at December 31:

	<u>2008</u>	<u>2007</u>
Raw materials and fabricated parts	\$ 11,456,242	\$ 9,805,000
Work in process	1,846,339	1,863,509
Finished goods	1,843,405	1,911,921
	<u>15,145,986</u>	<u>13,580,430</u>
Less reserve for obsolescence	(550,000)	(480,000)
	<u>\$ 14,595,986</u>	<u>\$ 13,110,430</u>

3 ACCOUNTS PAYABLE AND ACCRUED EXPENSES

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

	<u>2008</u>	<u>2007</u>
Accounts payable	\$ 2,582,060	\$ 2,186,956
Compensation and related payroll taxes	822,883	935,159
Interest	30,262	24,322
Self-insurance liability	76,000	62,000
Product warranty liability	137,000	47,000
Other	38,856	22,825
	<u>\$ 3,687,061</u>	<u>\$ 3,278,262</u>

ACCOUNTS PAYABLE AND ACCRUED EXPENSES (continued)

The Company sponsors 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 \$60,000 per person per policy year, with the total plan exposure to the Company capped at approximately \$800,000 per policy year. The plan provides contributory coverage for employees and their dependents. The Company's contributions totaled approximately \$520,000, \$570,000 and \$461,000 for the years ended December 31, 2008, 2007 and 2006, respectively. At December 31, 2008 and 2007, the Company recorded \$76,000 and \$62,000, respectively, of accruals based on the aggregate amount of the liability for reported claims and an estimated liability for claims incurred but not reported.

4 LINE OF CREDIT

The Company has a revolving line of credit agreement with a bank for borrowings up to a maximum of \$5,000,000. The amount outstanding under this agreement was \$2,300,000 and \$3,000,000 at December 31, 2008 and 2007, respectively. The agreement provides for interest, payable monthly, at the bank's prime rate (3.25% at December 31, 2008) minus 0.50%, with an option to use an interest rate based on LIBOR (1.90% at December 31, 2008) plus 1.50%. At December 31, 2008, the entire amount was outstanding at 2.75%. 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 2009. As such, the line of credit is classified as current debt at December 31, 2008 on the accompanying financial statements. At December 31, 2007, the amount outstanding under this line was \$3,000,000 and was classified as noncurrent debt.

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, but not limited to, paying dividends, purchases of treasury stock and fixed assets. At December 31, 2008, the Company was in compliance with all the covenant requirements.

5 LONG-TERM DEBT

Long-term debt at December 31 is as follows:

	<u>2008</u>	<u>2007</u>
Note payable, bank, secured by first deed of trust on real estate, payable in monthly installments of \$4,102 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).	\$ 2,502,768	\$ 2,552,547
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.	<u>606,458</u>	<u>699,455</u>
	3,109,226	3,252,002
Less current maturities of long-term debt	(153,877)	(142,776)
	<u>\$ 2,955,349</u>	<u>\$ 3,109,226</u>

LONG-TERM DEBT (continued)

Aggregate maturities of long-term debt as of December 31, 2008 are as follows:

Years Ending December 31,	
2009	\$ 153,877
2010	165,847
2011	178,757
2012	272,680
2013	687,697
Thereafter	<u>1,650,368</u>
	<u>\$ 3,109,226</u>

6 INCOME TAXES

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

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Current:			
Federal	\$ 1,056,388	\$ 1,341,923	\$ 1,069,857
State	<u>249,788</u>	<u>257,194</u>	<u>247,843</u>
	<u>1,306,176</u>	<u>1,599,117</u>	<u>1,317,700</u>
Deferred	<u>(66,000)</u>	<u>(221,000)</u>	<u>(301,000)</u>
	<u>\$ 1,240,176</u>	<u>1,378,117</u>	<u>\$ 1,016,700</u>

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

	<u>2008</u>	<u>2007</u>	<u>2006</u>
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	<u>(2)</u>	<u>(3)</u>	<u>(1)</u>
	<u>37%</u>	<u>36%</u>	<u>38%</u>

INCOME TAXES (continued)

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

	<u>2008</u>	<u>2007</u>
Deferred tax assets:		
Inventory reserve and capitalization	483,000	374,000
Accrued compensation	162,000	304,000
Unrealized loss on swap contract	135,000	-
Other	138,000	86,000
	<u>918,000</u>	<u>764,000</u>
Deferred tax liabilities:		
Depreciation and amortization	\$ (70,000)	\$ (83,000)
Undistributed DISC income	(67,000)	(101,000)
	<u>(137,000)</u>	<u>(184,000)</u>
	<u>\$ 781,000</u>	<u>\$ 580,000</u>

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

	<u>2008</u>	<u>2007</u>
Current assets	\$ 783,000	\$ 764,000
Long-term liabilities	(2,000)	(184,000)
	<u>\$ 781,000</u>	<u>\$ 580,000</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, which equates to federal tax of 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 PLAN

The Company has a stock option plan covering the Company's common shares. Nonqualified stock options may be issued to officers, directors or key employees of the Company under the plan. Qualified stock options may be issued to employees of the Company under the plan. 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 plan 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.

STOCK OPTION PLAN (continued)

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

	2008		2007		2006	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year:	527,500	\$1.13	750,000	\$ 1.07	150,000	\$ 0.84
Granted	-	-	-	-	600,000	1.13
Forfeited	(35,000)	1.05	(10,000)	1.05	-	-
Canceled	-	-	(49,500)	0.82	-	-
Exercised	(27,500)	1.05	(163,000)	0.97	-	-
Outstanding at end of year	<u>465,000</u>	1.14	<u>527,500</u>	1.13	<u>750,000</u>	1.07
Options exercisable, end of year	<u>200,000</u>	1.14	<u>85,000</u>	1.11	<u>112,500</u>	0.84
Options available for grant, end of year	<u>45,000</u>		<u>10,000</u>		<u>-</u>	

The following table summarizes information about stock options outstanding at December 31, 2008:

Exercise Price	Number Outstanding	Remaining Contractual Life (in Years)	Number Exercisable
\$ 1.155	397,500	7.5	167,500
1.05	<u>67,500</u>	7.5	<u>32,500</u>
	<u>465,000</u>		<u>200,000</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, are at least 21 years old and are not covered by collective bargaining agreements. 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 and profit sharing contributions. The Company made discretionary matching contributions of approximately \$81,000 and \$92,000 and no discretionary profit sharing contributions for the years ended December 31, 2008 and 2007, respectively. The Company did not make any discretionary matching or profit sharing contributions to the plan during the year ended December 31, 2006.

EMPLOYEE BENEFIT PLANS (continued)

Deferred Compensation Agreement

The Company has established nonqualified deferred compensation agreements for certain key employees. The agreements provide for a total benefit of \$169,000. 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, 2008 and 2007, the accrued liability related to these agreements amounted to \$68,353 and \$44,660, respectively. Deferred compensation expense amounted to approximately \$23,693, \$15,800 and \$7,300 for the years ended December 31, 2008, 2007 and 2006, respectively.

9 LEASE COMMITMENT

The Company has 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. At December 31, 2008 future minimum lease payments amounted to approximately \$88,000.

Rent was approximately \$162,000 for the year ended December 31, 2008. Rent expense was approximately \$224,000 for both years ended December 31, 2007 and 2006.

10 INTEREST RATE SWAP AGREEMENT

As disclosed in Note 5, the Company has entered into an interest rate swap agreement with the bank that effectively fixed the note payable in the original amount of \$2,650,000 (\$2,502,768 at December 31, 2008) at a rate of 6.49% until October 2015. The notional amount under the swap decreases as principal payments are made on the note so that the notional amount equals the principal outstanding under the note. The swap is designed to hedge the risk of changes in interest payments on the note caused by changes in LIBOR.

The swap was issued at market terms so that it had no fair value at its inception. The carrying amount of the swap has been adjusted to its fair value at December 31, 2008, which because of changes in forecasted levels of LIBOR resulted in reporting a liability for the fair value of the future net payments forecasted under the swap. The liability is classified as noncurrent since management does not intend to settle it during 2009. Since the critical terms of the swap and the note are the same, the swap is assumed to be completely effective as a hedge, and none of the change in its fair value is included in pretax income. Accordingly, all of the adjustment of the swap's carrying amount is reported as other comprehensive loss. For the years ended December 31, 2007 and 2006, changes in the swap's fair value were insignificant and therefore no gain or loss was recorded in other comprehensive income.

11 PLANT CLOSURE

In May 2008, the Company closed down its manufacturing facility in Connecticut. All of the operations of the Connecticut facility were relocated to the Company's other facilities. As a result of the closure, the Company incurred employee termination and relocation costs as well as machinery and equipment moving expenses. Total costs related to the closure amounted to approximately \$165,000 (impact on basic and diluted EPS of (\$0.04) per share) and are included as part of other expenses in the accompanying statements of 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, 2008 and 2007 and the related statements of income, stockholders' equity and cash flows for each of the years in the three year period ended December 31, 2008. 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 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 financial statements referred to above present fairly, in all material respects, the financial position of Semco Instruments, Inc. as of December 31, 2008 and 2007, and the results of its operations and its cash flows for each of the years in the three year period ended December 31, 2008, in conformity with accounting principles generally accepted in the United States of America.

Hutchinson and Bloodgood LLP

April 3, 2009

Financial Highlights

FIVE YEAR SUMMARY	2008	2007	2006	2005	2004
Income Statement Data					
Net income	\$ 2,156,166	\$ 2,416,542	\$ 1,690,950	\$ 489,466	\$ 534,429
Return on sales	6.5%	7.1%	6.0%	2.0%	2.2%
Earnings per share	0.47	0.55	0.39	0.11	0.12
Weighted average # of shares outstanding	4,550,539	4,421,437	4,377,329	4,377,329	4,397,954
Net sales	33,291,842	34,201,540	28,318,920	24,448,701	23,772,804
Cost of sales	26,382,830	26,860,362	22,565,033	20,924,142	20,132,608
Gross profit margin	20.8%	21.5%	20.3%	14.4%	15.3%
Selling, general & administrative expense	3,015,932	3,123,640	2,712,465	2,386,992	2,497,970
Selling, general & administrative % of sales	9.1%	9.1%	9.6%	9.8%	10.5%
Interest expense, net	325,468	428,805	390,758	344,539	344,790
EBITDA	4,039,131	4,564,697	3,479,944	1,565,644	1,591,851
EBITDA margin	12.1%	13.3%	12.3%	6.4%	6.7%
Working Capital					
Quick ratio	0.8	1.3	0.6	0.9	0.5
Current ratio	3.3	5.4	2.6	3.1	1.7
Days sales in receivables	50	47	49	49	49
Working capital as % of sales	43.1%	44.5%	34.2%	32.6%	20.5%
Inventory turnover	1.9	2.2	2.4	2.6	2.8
Leverage and Other					
Asset turnover	1.51	1.73	1.72	1.67	1.68
Stockholder's equity	13,427,360	11,456,569	8,839,641	7,129,691	6,640,225
Return on stockholders' equity	16.1%	21.1%	19.1%	6.9%	8.0%
Liabilities and Debt/Equity	0.7	0.9	1.1	1.0	1.2
Liabilities and Debt/Assets	0.4	0.5	0.5	0.5	0.6

DIRECTORS

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Semco Instruments, Inc.

Arnold Twersky
Certified Public Accountant
Northridge, California

Samuel J. Moore
Sales Manager
Semco Instruments, Inc.

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Michael G. Moore – President
Samuel J. Moore – Secretary/Treasurer

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