Semco

INSTRUMENTS, INC.

ANNUAL
REPORT
2009

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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Financial Highlights 16

To Our Shareholders:

Net sales achieved by your Company in 2009 were $38,536,930 as compared to 2008 sales of $33,291,842. Pre-tax income was $6,049,262 in 2009 as compared to 2008 pre-tax income of $3,396,342, and net income was $3,772,246 or $0.81 per share in 2009 as compared to a 2008 net income of $2,156,166 or $0.47 per share.

Sales growth in 2009 was 15.8% over 2008 levels and this was reflective of both increased military demand and improved production throughput. In September 2009 the Company received a 5 year requirements contract from the Defense Logistics Agency which has an estimated value of $10,800,000 and a maximum value of $20,700,000. The Company's backlog remains healthy, reflecting continued strong demand for military product and a slight softening of demand for product serving the commercial segment of the market and in particular the business jet segment. The Company has experienced reduced new design activity from existing customers, reflecting a pull-back by commercial customers due to economic conditions. In response the Company has launched increased efforts to capture business with new customers who are seeking a qualified supplier with low labor costs and/or who are experiencing poor service or poor product quality from competitors. We have found this to be an opportunity with significant potential.

The Company achieved a 9.8% return on sales in 2009, an increase in profitability over the 6.5% return on sales achieved in 2008. The 75% increase in the level of profitability was reflective of increased sales, the efficiencies of volume, shipped product mix as well as an organizational culture and structure that is lean and focused on improvement. It is also reflective of the efficiencies achieved through increased utilization of our Nogales, Mexico manufacturing facility.

The Nogales facility produced 57% of the Company's shipments in 2009 and we continue to focus resources on growing the skills and capacity of this low cost facility. In December 2009 the Nogales facility was audited by Det Norske Veritas to the ISO9001-2008 and AS9100:2004 quality standards and was officially registered to these standards in March 2010. It is our expectation that the Nogales facility will continue to grow in its importance to the overall business.

While the current economic conditions present a challenge, 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.

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	
	2009	**2008**
Current assets		
Cash and cash equivalents	**$ 3,123,274**	$ 167,050
Accounts receivable	**4,814,213**	4,564,679
Inventories	**12,144,000**	14,595,986
Prepaid expenses and other current assets	**295,559**	393,067
Deferred income taxes	**582,000**	783,000
Total current assets	**20,959,046**	20,503,782
Property, plant and equipment		
Land and improvements	**980,356**	980,356
Building and improvements	**2,342,262**	2,340,112
Machinery and equipment	**2,476,646**	2,433,325
Automotive equipment	**137,241**	137,241
Furniture, fixtures and computers	**1,048,354**	1,042,485
	6,984,859	6,933,519
Less accumulated depreciation and amortization	**(4,779,655)**	(4,494,816)
	2,205,204	2,438,703
Deferred income taxes	**41,000**	–
Deposits	**17,515**	17,515
	58,515	17,515
	$23,222,765	$22,960,000

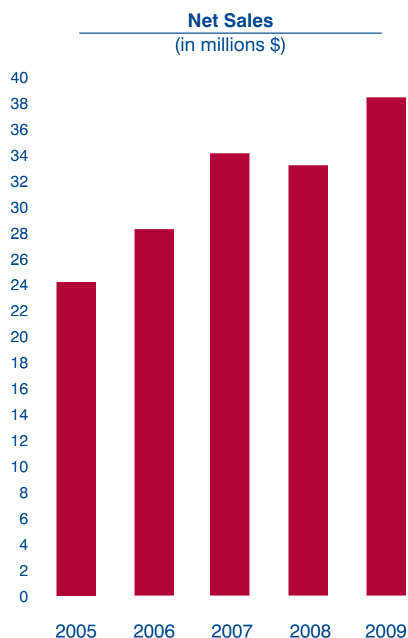
LIABILITIES AND STOCKHOLDERS' EQUITY	2009	2008
Current liabilities		
Line of credit	**$ –**	$ 2,300,000
Current maturities of long-term debt	**56,772**	153,877
Accounts payable and accrued expenses	**2,912,587**	3,687,061
Total current liabilities	**2,969,359**	6,140,938
Noncurrent liabilities		
Long-term debt, less current maturities	**2,392,836**	2,955,349
Deferred compensation payable	**96,839**	68,353
Deferred income taxes	**–**	2,000
Obligation under interest rate swap	**237,000**	366,000
Total noncurrent liabilities	**2,726,675**	3,391,702
Commitment and Contingencies (Notes 3, 9 and 10)		
Stockholders' equity		
Common stock, $0.01 par value; 6,000,000 shares authorized, 4,824,204 (2009) and 4,649,204 (2008) shares issued and outstanding	**48,242**	46,492
Additional paid-in-capital	**1,314,865**	1,071,490
Accumulated other comprehensive loss	**(149,000)**	(231,000)
Retained earnings	**16,329,678**	12,557,432
	17,543,785	13,444,414
Less treasury stock, at cost, 86,625 shares	**(17,054)**	(17,054)
Total stockholders' equity	**17,526,731**	13,427,360
	$23,222,765	$22,960,000

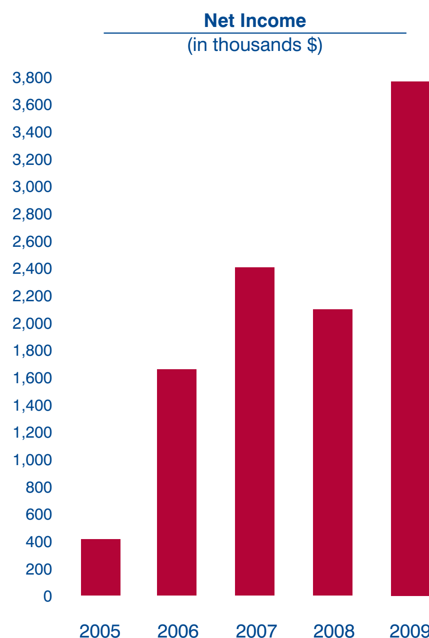
The Notes to Financial Statements are an integral part of these statements.

Statements of Income

	Years Ended December 31		
	2009	**2008**	**2007**
Net sales	**$38,536,930**	$33,291,842	$34,201,540
Cost of sales	**29,475,081**	26,382,830	26,860,362
Gross profit	**9,061,849**	6,909,012	7,341,178
Selling, general and administrative expenses	**2,803,911**	3,015,932	3,123,640
income from operations	**6,257,938**	3,893,080	4,217,538
Other income (expense):			
Interest expense	**(219,463)**	(330,827)	(444,616)
Interest income	**11,305**	5,359	15,811
Other	**(518)**	(171,270)	5,926
	(208,676)	(496,738)	(422,879)
Income before provision for income taxes	**6,049,262**	3,396,342	3,794,659
Provision for income taxes	**2,277,016**	1,240,176	1,378,117
Net income	**$ 3,772,246**	$ 2,156,166	$ 2,416,542
Earnings per common share:			
Basic	**$ 0.81**	$ 0.47	$ 0.55
Diluted	**$ 0.80**	$ 0.44	$ 0.54
Weighted average number of common shares outstanding, basic	**4,640,250**	4,550,539	4,421,437
Weighted average number of common shares outstanding, diluted	**4,735,906**	4,871,898	4,474,817

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

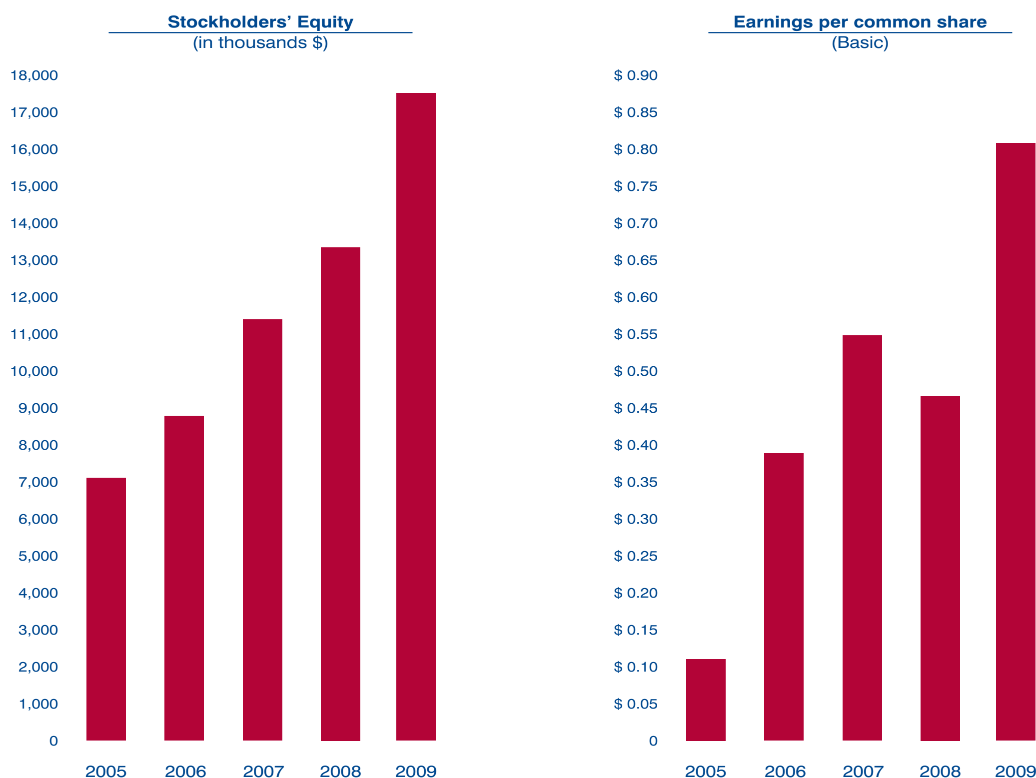




Statements of Stockholders' Equity

	Common Stock		Additional	Accomulated Other		Treasury Stock, at Cost		
	Outstanding Shares	Amount	Paid-in Capital	Comprehensive Income (Loss)	Retained Earnings	Shares	Amount	Total
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
Net income	–	–	–	–	3,772,246	–	–	3,772,246
Change in fair value of interest rate swap contract, net of tax	–	–	–	82,000	–	–	–	82,000
Shares reacquired and canceled	–	–	–	–	–	–	–	–
Exercise of Stock Options	175,000	1,750	200,375	–	–	–	–	202,125
Stock-based compensation	–	–	43,000	–	–	–	–	43,000
Balance, December 31, 2009	**4,824,204**	**$ 48,242**	**$ 1,314,865**	**(149,000)**	**$16,329,678**	**86,625**	**$ (17,054)**	**$17,526,731**

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



Statements of Cash Flows

	Years Ended December 31		
	2009	**2008**	**2007**
Cash Flows from Operating Activities			
Net income	**$ 3,772,246**	$ 2,156,166	$ 2,416,542
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	**287,277**	317,321	341,233
Stock-based compensation	**43,000**1	43,000	43,000
Loss (gain) on disposal of equipment	**–**	3,336	(33,500)
Deferred income taxes	**111,000**	(66,000)	(221,000)
Changes in operating assets and liabilities			
Increase in accounts receivables	**(249,534)**	(181,384)	(589,399)
Decrease (increase) in inventories	**2,451,986**	(1,485,556)	(1,885,379)
Decrease (increase) in prepaid expenses and other current assets	**97,508**	(157,114)	(171,628)
Decrease in income taxes payable	**–**	–	(155,000)
Increase (decrease) in accounts payable and accrued expenses	**(745,988)**	432,492	489,130
Net cash provided by operating activities	**5,767,495**	1,062,291	233,999
Cash Flows from Investing Activities			
Purchase of equipment and improvements	**(53,778)**	(246,800)	(297,824)
Proceeds from sale of equipment	**–**	42,333	43,975
Net cash used in investing activities	**(53,778)**	(204,467)	(253,849)
Cash Flows from Financing Activities			
Net repayments on line of credit	**(2,300,000)**	(700,000)	–
Repayments on long-term debt	**(659,618)**	(142,776)	(132,483)
Net proceeds from exercise of stock options	**202,125**	2,625	157,386
Net cash provided by (used in) financing activities	**(2,757,493)**	(840,151)	24,903
Net increase in cash and cash equivalents	**$ 2,956,224**	$ 17,673	$ 5,053
Cash and cash equivalents			
Beginning	**167,050**	149,377	144,324
Ending	**$ 3,123,274**	$ 167,050	$ 149,377
Supplemental Disclosures of Cash Flow Information			
Interest paid	**$ 242,294**	$ 324,897	$ 446,648
Income taxes paid	**$ 2,070,000**	$ 1,466,000	$ 1,639,000
Supplemental Disclosures of Non Cash Investing and Financing Activities			
Interest rate swap contract:			
Change in deferred income related to unrealized loss	**$ (47,000)**	$ 135,000	$ –
Change in obligation	**$ 129,000**	$ (366,000)	$ –
Change in fair value	**$ (82,000)**	$ 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) (a Delaware corporation) 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.

Subsequent Events

The Company has evaluated subsequent events for recognition or disclosure through March 31, 2010, which is the date that the Company's financial statements were available to be issued.

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 and product warranty 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, 2009 and 2008.

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 67% of its net sales from three customers during 2009. Individually, the three customers accounted for 27%, 26% and 14% of net sales. These three customers represented 68% of accounts receivable at December 31, 2009. 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.

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.

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

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:

	Years
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, 2009, 2008 and 2007 management has determined that no impairment of long-lived assets existed.

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

The Company has a stock option plan covering the Company's common shares, which is described more fully in Note 7. The Company records compensation expense associated with stock-based awards 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 for each of the years ended December 31, 2009, 2008 and 2007, respectively.

Notwithstanding options granted in the future and based on the stock-based compensation awards outstanding as of December 31, 2009, the Company expects to recognize additional pre-tax compensation cost in future years as follows:

2010	2011	2012	2013	2014	**Total**
$31,000	$11,000	$11,000	$11,000	$10,000	**$74,000**

The fair value of options granted during 2009 was estimated at the grant date using the Black-Scholes option pricing method, with the following assumptions: estimated volatility of 35.00%, risk-free interest rate of 2.15%, the options would be exercised at the end of the exercise period and the Company would declare no dividends. There were 50,000 options granted during 2009. No options were granted during 2008 and 2007.

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

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, 2009 and 2008.

The Company uses a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions are recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold are recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold are derecognized in the first subsequent financial reporting period in which that threshold is no longer met.

Earnings Per Share (EPS)

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 weighted average number of common shares from options not exercised during the year. 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:

	2009	2008	2007
Shares outstanding, basic EPS	**4,640,250**	4,550,539	4,421,437
Effect of dilutive securities, employee stock options	**95,656**	321,359	53,380
Shares outstanding, diluted EPS	**4,735,906**	4,871,898	4,474,817

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

New Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2009-01 (formerly Statement No. 168), Topic 105 - Generally Accepted Accounting Principles - FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles. The Codification is the single source of authoritative nongovernmental U.S. generally accepted accounting principles (GAAP). The Codification does not change current GAAP, but is intended to simplify user access to all authoritative GAAP by providing all the authoritative literature related to a particular topic in one place. All existing accounting standard documents are superseded and all other accounting literature not included in the Codification is considered non-authoritative. The Codification is effective for interim or annual reporting periods ending after September 15, 2009. Management has made the appropriate changes to GAAP references in the financial statements.

In May 2009, the FASB issued Accounting Standards Codification (ASC) 855 (formerly Statement No. 165), Subsequent Events. ASC 855 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or available to be issued. ASC 855 is effective for interim or annual periods ending after June 15, 2009. Management has adopted the provisions of ASC 855 and this change is reflected in Note 1 under the heading "Subsequent Events."

2 INVENTORIES

Inventories consist of the following at December 31:

	2009	2008
Raw materials and fabricated parts	**$ 9,247,999**	$11,456,242
Work in process	**1,241,205**	1,846,339
Finished goods	**2,104,796**	1,843,405
	12,594,000	15,145,986
Less reserve for obscolescence	**(450,000)**	(550,000)
	$ 12,144,000	$14,595,986

3 ACCOUNTS PAYABLE AND ACCRUED EXPENSES

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

	2009	2008
Accounts payable	**$ 1,931,041**	$ 2,582,060
Compensation and related payroll taxes	**800,232**	822,883
Interest	**7,431**	30,262
Self-insurance liability	**50,000**	76,000
Product warranty liability	**110,000**	137,000
Other	**13,883**	38,856
	$ 2,912,587	$ 3,687,061

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 $702,000 per policy year. The plan provides for contributory coverage for employees and their dependents. The Company's contributions totaled approximately $401,000, $520,000 and $570,000 for the years ended December 31, 2009, 2008 and 2007, respectively. At December 31, 2009 and 2008, the Company recorded $50,000 and $76,000, respectively, of accruals based on the aggregate amount of the liability for unpaid reported claims and an estimated liability for claims incurred but not reported.

4 LINE OF CREDIT

As of December 31, 2008, the Company had a revolving line of credit agreement (the agreement) with a bank for borrowings up to a maximum of $5,000,000. The amount outstanding under this agreement was $2,300,000 at December 31, 2008. The agreement provided 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 was collateralized by all assets of the Company, including accounts receivables, inventories, equipment and fixtures. The line of credit matured in June 2009 and was paid off.

In May 2009, the Company entered into a revolving line of credit agreement (the agreement) with a new bank for borrowings up to a maximum of $5,000,000. The agreement provides for interest payable, monthly, at the borrowers option of either i) the bank's prime rate (3.25% at December 31, 2009), ii) LIBOR rate (1.02% at December 31, 2009) plus 2.00%, limited by a rate floor of 4.00% per annum, for a fixed period of 30 days, iii) LIBOR rate plus 2.00%, limited by a rate floor of 4.00% per annum, for a fixed period of 60 days, iv) LIBOR rate plus 2.150% for a fixed period of 90 days. The line of credit is collateralized by all assets of the Company, including accounts receivables, inventories, equipment and fixtures and matures in June 2010. At December 31, 2009, there were no amounts outstanding under this agreement.

In addition, the agreement provides for an additional equipment credit facility for borrowings up to a maximum of $750,000, not to exceed 85% of the purchase price of new and/or used machinery and equipment per advance. The agreement provides for interest payable, monthly, at the borrowers option of either i) the bank's prime rate, ii) U.S. Treasury Securities rate (1.02% at December 31, 2009) plus 2.00%, subject to a floor rate of 6.25% per annum. Each advance has a maximum term of 48 months from the time of funding. The line matures in June 2010. At December 31, 2009, there were no amounts outstanding on this equipment credit facility.

The line of credit agreement 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. At December 31, 2009, the Company was in compliance with all the covenant requirements.

5 LONG-TERM DEBT

Long-term debt at December 31 is as follows:

	2009	2008
Note payable, bank, secured by first deed of trust on real estate, payable in monthly installments of $4,380 plus interest at the bank's prime rate plus 0.5% maturing on October 1, 2015, subject to an interest rate swap agreement, which effectively fixed the interest rate at 6.49% (see Note 10).	**$ 2,449,608**	$ 2,502,768
Note payable, former acquisition indebtedness, 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%. The note was paid in full in June 2009	**–**	606,458
	2,449,608	3,109,226
Less current maturities of long-term debt	**(56,772)**	(153,877)
	$ 2,392,836	$ 2,955,349

Aggregate future maturities of long-term debt as of December 31, 2009 are as follows:

Years Ending December 31,	
2010	$ 56,772
2011	60,628
2012	144,747
2013	549,145
2014	554,242
Thereafter	1,084,074
	$ 2,449,608

6 INCOME TAXES

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

	2009	2008	2007
Current:			
Federal	**$ 1,826,655**	$ 1,056,388	$ 1,341,923
State	**339,361**	249,788	257,194
	2,166,016	1,306,176	1,599,117
Deferred tax expense (benefit)	**111,000**	(66,000)	(221,000)
	$ 2,277,016	1,240,176	$ 1,378,117

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

	2009	2008	2007
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)**	(2)	(3)
	38%	37%	36%

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

	2009	2008
Deferred tax assets:		
Inventory reserve and capitalization	**389,000**	483,000
Accrued compensation	**122,000**	162,000
Unrealized loss on swap contract	**88,000**	135,000
Other	**105,000**	138,000
	704,000	918,000
Deferred tax liabilities:		
Depreciation and amortization	**$ (47,000)**	$ (70,000)
Undistributed DISC income	**(34,000)**	(67,000)
	(81,000)	(137,000)
	$ 623,000	$ 781,000

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

	2009	2008
Current assets	**$ 582,000**	$ 783,000
Non current assets	**41,000**	–
Non current liabilities	**–**	(2,000)
	$ 623,000	$ 781,000

INCOME TAXES (continued)

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 had 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.

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

	2009		2008		2007	
	Shares	**Weighted Average Exercise Price**	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year:	**465,000**	**$1.14**	527,500	$ 1.13	750,000	$ 1.07
Granted	**50,000**	**4.30**	–	–	–	–
Forfeited	**(100,000)**	**1.16**	(35,000)	1.05	(10,000)	1.05
Canceled	**–**	**–**	–	–	(49,500)	0.82
Exercised	**(175,000)**	**1.16**	(27,500)	1.05	(163,000)	0.97
Outstanding at end of year	**240,000**	**1.78**	465,000	1.14	527,500	1.13
Options exercisable, end of year	**82,500**	**1.09**	200,000	1.14	85,500	1.11
Options available for grant, end of year	**95,000**		45,000		10,000	

The following table summarizes information about stock options outstanding at December 31, 2009:

Exercise Price	**Number Outstanding**	**Remaining Contractual Life (in Years)**	**Number Exercisable**
$ 1.155	122,500	1.5	32,500
1.05	67,500	1.5	50,000
4.30	50,000	5.0	–
	240,000		82,500

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 $62,000, $81,000 and $92,000 and no discretionary profit sharing contributions for the years ended December 31, 2009, 2008 and 2007, respectively.

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, 2009 and 2008, the accrued liability related to these agreements amounted to $96,839 and $68,353, respectively. Deferred compensation expense amounted to $28,486, $23,693 and $15,800 for the years ended December 31, 2009, 2008 and 2007, respectively.

9 LEASE COMMITMENT

The Company has entered into a two-year non-cancelable operating lease agreement expiring in September 2011 for one of its manufacturing facilities, with monthly lease payments of approximately $9,800. At December 31, 2009 future minimum lease payments amounted to approximately $117,000 and $89,000 for the years ending December 31, 2010 and 2011, respectively.

Rent expense on this facility was approximately $117,000 for each of the years ended December 31, 2009, 2008, and 2007.

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 ($2,449,608 at December 31, 2009) 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 adjustment at its inception. The carrying value of the swap is adjusted to its fair value as changes in forecasted levels of LIBOR result in recording 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 2010. 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 fair value adjustment to the swap's carrying value is reported as other comprehensive loss. At December 31, 2009 and 2008, The Company reported a liability of $237,000 and $366,000, respectively. For the year ended December 31, 2007, changes in the swap's fair value were insignificant and therefore no gain or loss was recorded in other comprehensive income.

11 FAIR VALUE MEASUREMENT

The Company has fully adopted ASC 820, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. ASC 820 applies only to fair value measurements already required or permitted by other accounting standards and does not impose requirements for additional fair value measures.

FAIR VALUE MEASUREMENT (continued)

ASC 820 establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

- Level 1 inputs are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 inputs include quoted prices for similar assets and liabilities in active markets, quoted prices for identical assets and liabilities in inactive markets, inputs that are observable for the asset or liability (such as interest rates, prepayment speeds, credit risks, etc.), or inputs that are derived principally from or corroborated by observable market data by correlation or by other means.
- Level 3 inputs are unobservable and reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

Fair Value Measured on a Non Recurring Basis

The Company had one financial liability, for which fair value measurements are performed on a non recurring basis:

	Fair Value Measurements Using		
	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
At December 31, 2009			
Obligation under interest rate swap	$ –	$ 237,000	$ –
At December 31, 2008			
Obligation under interest rate swap	$ –	$ 366,000	$ –

The fair values of the Company's obligation under interest rate swap agreement is determined using Level 2 inputs, based on an estimate provided by the counterparty to the agreement.

HUTCHINSON and BLOODGOOD LLP
CERTIFIED PUBLIC ACCOUNTANTS AND CONSULTANTS

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, 2009 and 2008 and the related statements of income, stockholders' equity and cash flows for each of the years in the three year period ended December 31, 2009. 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, 2009 and 2008, and the results of its operations and its cash flows for each of the years in the three year period ended December 31, 2009, in conformity with accounting principles generally accepted in the United States of America.

Hutchinson and Bloodgood LLP

March 31, 2010

Financial Highlights

FIVE YEAR SUMMARY	2009	2008	2007	2006	2005
Income Statement Data					
Net income	$ 3,772,246	$ 2,156,166	$ 2,416,542	$ 1,690,950	$ 489,466
Return on sales	9.8%	6.5%	7.1%	6.0%	2.0%
Earnings per share	0.81	0.47	0.55	0.39	0.11
Weighted average # of shares outstanding	4,640,250	4,550,539	4,421,437	4,377,329	4,377,329
Net sales	38,536,930	33,291,842	34,201,540	28,318,920	24,448,701
Cost of sales	29,475,081	26,382,830	26,860,362	22,565,033	20,924,142
Gross profit margin	23.5%	20.8%	21.5%	20.3%	14.4%
Selling, general & administrative expense	2,803,911	3,015,932	3,123,640	2,712,465	2,386,992
Selling, general & administrative % of sales	7.3%	9.1%	9.1%	9.6%	9.8%
Interest expense, net	208,158	325,468	428,805	390,758	344,539
EBITDA	6,544,697	4,039,131	4,564,697	3,479,944	1,565,644
EBITDA margin	17.0%	12.1%	13.3%	12.3%	6.4%
Working Capital					
Quick ratio	2.7	0.8	1.3	0.6	0.9
Current ratio	7.1	3.3	5.4	2.6	3.1
Days sales in receivables	46	50	47	49	49
Working capital as % of sales	46.7%	43.1%	44.5%	34.2%	32.6%
Inventory turnover	2.2	1.9	2.2	2.4	2.6
Leverage and Other					
Asset turnover	1.67	1.51	1.73	1.72	1.67
Stockholder's equity	17,526,731	13,427,360	11,456,569	8,839,641	7,129,691
Return on stockholders' equity	21.5%	16.1%	21.1%	19.1%	6.9%
Liabilities and Debt/Equity	0.3	0.7	0.9	1.1	1.0
Liabilities and Debt/Assets	0.3	0.4	0.5	0.5	0.5

DIRECTORS

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Northridge, California

Gerold W. Libby
Partner
Zuber & Taillieu, LLP

Samuel J. Moore
Sales Manager
Semco Instruments, Inc.

Daniel C. deBrauwere
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CRG Partners

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Samuel J. Moore – Secretary/Treasurer

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