PECO II INC
Form 10-K
March 31, 2010

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

þ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2009

Commission file number: 000-31283

PECO II, INC.

(Exact name of registrant as specified in its charter)

Ohio	34-1605456
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1376 State Route 598, Galion, Ohio 44833
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (419) 468-7600

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

Common Shares, without par value	Nasdaq
(Title of each class)	(Name of each exchange on which registered)

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

None

Indicate by check mark if the registrant is a well-known seasoned issuer as defined in Rule 405 of the Securities Act. Yes £ No þ

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. þ

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	o	Accelerated filer	o
Non-accelerated filer	o	Smaller reporting company	þ
(Don't check if a smaller reporting company)			

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

The aggregate market value of the registrant's common shares, without par value, held by non-affiliates of the registrant was approximately $5.3 million on June 30, 2009.

On March 16, 2010, the registrant had outstanding 2,859,466 of its common shares, without par value.

DOCUMENTS INCORPORATED BY REFERENCE

None

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PART I

ITEM 1—BUSINESS

All references to "we," "us," "our," "PECO II," or the "Company" in this Annual Report on Form 10-K mean PECO II, Inc.

PECO II, Inc. was incorporated in Ohio in 1988. Our headquarters is located at 1376 State Route 598 in Galion, Ohio 44833 and our telephone number is (419) 468-7600. Our corporate web site address is www.peco2.com.

In 1988, we acquired the assets of ITT's communications power product business. In August 2000, we completed an initial public offering of 575,000 of our common shares resulting in net proceeds to us of $78.3 million. We made two strategic acquisitions in 2001 to expand our engineering and installation, or E&I, services capabilities. In June 2001, we acquired Thornton Communications and in August 2001, we acquired JNB Communications. On March 28, 2006, the Company acquired the assets related to the Telecom Power Division of Delta Products Corporation, which consisted of certain wireline and wireless communications providers contracts and related inventory and assumed the liabilities associated therewith. In exchange, we issued 474,037 of our common shares without par value (the "Primary Shares") and a warrant to purchase up to approximately 1.3 million of our common shares, or such other number of shares that, when aggregated with the Primary Shares, represented 45% of our issued and outstanding shares of common stock. The warrant expired unexercised in September 2008.

On February 18, 2010, we entered into an Agreement and Plan of Merger (merger agreement) with Lineage Power Holdings, Inc. (Lineage), a Gores Group company and a provider of intelligent power conversion solutions, and Lineage Power Ohio Merger Sub, Inc., a wholly-owned subsidiary of Lineage. Under the terms of the merger agreement, Lineage will acquire all of the outstanding shares of PECO II for $5.86 per share in cash without interest and less any applicable tax withholding. The Board of Directors of both PECO II and Lineage have unanimously approved the proposed transaction. The completion of the merger and other transactions contemplated by the merger agreement is subject to a number of conditions, including adoption at the special meeting of PECO II shareholders of the merger agreement and the merger.

We offer solutions to our telecommunication customers' cost, quality, productivity and capacity challenges by providing on-site E&I systems integration, installation, maintenance and monitoring services and by designing, assembling and marketing communications specific power products. The products we offer include power systems, power distribution equipment and systems integration products. Our power systems provide a primary supply of power to support the infrastructure of communications service providers, including local exchange carriers, long distance carriers, wireless service providers, internet service providers and broadband access providers. Our power distribution equipment directs this power to specific customer communications equipment. Our systems integration business provides complete built-to-order communications systems assembled and installed pursuant to customer specifications and incorporating other manufacturers' products. Our operations are organized within two segments: services and products. You can find more information regarding our two business segments in Note 2 to our consolidated financial statements located in Item 8 "Financial Statements and Supplementary Data" below.

Market Overview

We participate in the global telecommunication marketplace (wireline & wireless) with the majority of our current revenue being generated in North America. Our customers' network power needs are influenced by numerous factors, including size of the organization, number and types of technology systems deployed in the network and geographic coverage. The North American market consists of multiple segments that include Regional Bell Operating Companies (RBOCs), Independent Telephone Companies (IOCs), Inter-exchange Carriers/Competitive Access Providers, Wireless, Cable TV, Private Network/Enterprise, and Government.

Wireline companies, including the RBOCs and IOCs, continue to upgrade their respective networks to meet the increasing demands of their local service area. These carriers have been increasingly offering broadband access and triple play services. Most are currently deploying a next generation high-speed architecture such as FTTN (fiber to the node) or FTTP (fiber to the premises) in order to compete against the cable companies and the hybrid service offerings from local wireless providers.

Inter-exchange Carriers/Competitive Access Providers are experiencing tremendous pressure to identify their fit within the global telecommunication network. The Inter-exchange Carrier provides a connection between two parties outside an immediate serving area. Competitive Access Providers came into play after the Telecom Act of 1996 enabled local service competition within a given wireline market. Over the years, many of the Competitive Access Providers and Inter-exchange Carriers have merged or formed partnerships to compete against the incumbent telephone company in a given area. Recent regulatory changes have increased the competitive pressure and have created significant infrastructure write-offs as well as mergers and acquisitions activity in these sectors.

Wireless providers continue to build and expand. As a result of mergers and acquisitions within the wireless segment, there are four large North American organizations competing for the largest growth sector among individual subscribers. Wireless providers will likely continue to invest in infrastructure to move closer to their subscriber base, fill coverage gaps, and add traffic capacity, as well as upgrade facilities to provide the latest subscriber services via high speed wireless technologies such as EVDO (Evolution Version Data Only), HSPA (High Speed Packet Access), and UMTS (Universal Mobile Telecommunications System). Several carriers announced plans to begin introducing 4G solutions in 2009. The two primary 4G solutions are LTE (Long Term Evolution) and WiMAX (Worldwide Interoperability for Microwave Access).

Cable TV companies have traditionally offered video services to their subscriber base. However, in the past several years they have expanded to offer high speed data access that competes with the incumbent telephone company's DSL service. New high-speed data/video infrastructure builds are underway to offer VOIP (Voice Over Internet Protocol), and wireless services and protect their market from the new video and data offerings currently planned by local incumbent telephone companies.

The Private Network/Enterprise market traditionally had been focused on providing in-building dial tone services to commercial organizations, but has now expanded offerings based on evolving IT technology and business requirements. Steady growth in the Enterprise market is anticipated to continue to occur over the next five years as new services such as in-building wireless, video conferencing, and web page commerce are introduced. A key enabler of these new services is improvements in the support infrastructure to maintain these services during critical power failures.

The Government market is undergoing continued changes, especially as a result of the terrorist attacks of 2001. Communication infrastructure redesign is currently underway on a federal, state, and local basis. The current Homeland Security communication infrastructure build is expected to continue for the next several years. As a result of the American Recovery and Reinvestment Act, additional spending is expected in both government and carrier networks.

There has been significant and material consolidation within the service provider market segment, which is predicted to continue into 2010. This consolidation has reduced the actual number of service provider customers while significantly increasing their purchase power. Four of our largest customers several years ago are now one customer. This provides both new opportunities and risks in budget distractions driven by focused synergy efforts to provide significant cost savings across the new organization.

Our Business Strategy

Our strategy is to capitalize on the growing need to afford service providers a reliable source of power to run their networks in order to serve their customers today. These needs are found in wireline and wireless networks both at the service provider and enterprise level today. We provide our customers with solutions and related services that power their voice, data, and broadband offerings. Our long term strategy is to:

§ profitably grow revenues by continuing to flawlessly serve our customers;

§ improve our ability to touch more customers through the Company's indirect sales channel capability;

§ continually improve the talent level of our employees through coaching, training, and adding experienced industry talent to upgrade our overall capability;

§

continue to organically expand our customer base while we evaluate selective acquisitions to augment our current capabilities;

§ leverage alliances to operationally improve our customer responsiveness and grow our product and solution capability, enabling us to expand on technical competencies while lowering our cost structure;

§ leverage power system services competency to grow a national service capability;

§ penetrate further into customer markets where we currently have a strong services embedded base;

§ evaluate key markets for expansion based on leveraging our DC power competency;

§ leverage industry partnerships to provide “green” solutions that meet our customer’s expectations;

§ further develop system integration and assembly capability to ensure we maintain the most responsive resource in the industry; and

§ refine our product development processes to focus on systems integration skills and practices that reduce design cycle times, positioning us to capture market share in the fast-paced telecommunications market.

Business Segments

Our operations are organized within two segments: products and services.

Products

We continued to transform our product offering in 2009. We filled a key product category gap by developing a new small power platform to address the growing market for broadband outside plant and network edge power solutions. The size of the small, or micro, power market in the U.S. is estimated to reach $450 million by 2011, according to industry analyst Skyline Marketing. The inclusion of another platform to the Company's small power portfolio will position the Company to participate in this high growth sector during 2010 and beyond.

Our small product platforms are the Quantum™ Power System and the MPS Micro Power System. The Quantum platform is a 48-volt DC power system that combines high-density rectifiers, distribution and control in a sleek, low-profile shelf. It is optimized for telecom carriers deploying FTTN and traditional wireline architectures. Designed for the harsh outside plant environment, the Quantum system's small footprint makes it ideal for cabinets where rack space is at a premium. Both 23" and 19" Integrated Shelves were developed in 2008, along with a variety of distribution options. The Quantum system has achieved NEBS Level 3 Certification.

The MPS Micro Power System is a small power system designed for the network edge. Depending on configuration, the low profile system supplies anywhere from 18 Amps to 150 Amps of current at 48Vdc in a 1RU shelf by 19" wide shelf. The system contains up to three rectifiers, integrated distribution and a system controller. The controller provides standard DC power system management along with battery management, as well as an optional SNMP interface. Integrated distribution can include GMT fuses and a battery disconnect fuse, minimizing the size of the overall system and making it ideal for use in space-constrained remote cabinet applications. A primary application for the MPS is powering triple play solutions for multiple dwelling unit applications.

During the fourth quarter of 2009, we introduced our next generation mid-sized power plant products to the marketplace. These next generation 138 and 139 power plants utilize 1RU rectifiers and converters, incorporate a totally redesigned user interface, and implement reconfigured AC input and DC output interconnections. User friendliness, field serviceability, and cable management have all been significantly improved while preserving all tried and true customer practices. The 138 and 139 plants also support the growing number of "green" initiatives by incorporating high efficiency 1RU rectifiers and converters. Customer reaction has been very favorable. Several plants have already shipped to new customers and customers of existing mid-size power plants have expressed strong desire to move to the new power plants.

Our major product categories and building blocks are defined below:

Product Category	Purpose	Range of Products
Battery Plants	Convert and distribute power to run network equipment while storing energy in rechargeable batteries to be used in the event of an alternating current, or AC, input failure.	With capacities ranging from 3 to 10,000 Amperes, these systems are engineered for use in a wide number of applications, including central office, cellular, fiber optic, microwave, and broadband networks.
Rectifiers	Convert incoming AC power to DC power.	Our broad collection of rectifiers includes modules designed for larger applications as well as compact "hot swappable" modular switchmode rectifiers designed to be added or replaced without powering down the system.

Power Distribution Equipment	Distribute and limit power from a centralized power plant to various loads or end uses.	We offer a wide range of products from large battery distribution fuse boards, which provide intermediate distribution in applications where large power feeds from a power plant need to be split into smaller distributions, to smaller distribution circuits cabled directly to the load.
Converter Plants	Convert one voltage of DC power to another voltage of DC power.	Various models are available utilizing modules that provide 24V-48V and 48V-24V conversions.
Inverter Plants	Convert voltage from DC to AC power suitable for end-use applications. Provides continuous AC power in the event of a utility interruption.	Numerous systems are available based on our 1.2 kW modular “hot swappable” and “redundant” modules.

Services

In 2009, we continued our efforts to address the needs of our Tier I customer base. We strengthened our Central Office/Mobile Switching Center reputation and skill set by expanding out to new customers and markets. We expanded our cell site service capabilities, resulting in the award of Power turn key cell site deployment services contracts from Tier I wireless carriers. Additionally, we were awarded a renewal and major expansion of an existing contract with a Tier I provider. We continue to emphasize skill set expansion to deepen our solution set within our embedded customer base, while assisting with the establishment of new services offerings that will enable us to expand beyond our current power centric wireline/wireless reputation. Our portfolio of services solutions include:

- Capital Deployment Engineering & Installation (E&I) Services

DC Power (PECO II or other OEM products)

§ Large and Small Power Plants

§ Battery Install/Testing/Removals

§ Converter and/or Inverter Plants

Transmission

- Project Management

Multi-site Network Build Plans

Multi-site Maintenance and Emergency Support Services

- After Market Services

Cell Site/Remote Terminal Services

Power, Grounding, Site Expansion Audits

Preventative Maintenance Programs

Central Office/Main Switching Office Services

Power & Grounding Audits

Preventative Maintenance Program

Depot & Field Repair Services of DC Power Equipment

Advance Exchange

Product Upgrade and Refurbishment

- Staffing Services within Wireline & Wireless Telecommunication Sector

Engineering Personnel

Installation Personnel

Technical & Field Personnel

We will strive to continue to develop and enhance these services to maintain our strong quality and professional services reputation within the telecommunication industry.

Marketing and Sales

In 2009, our focus was on growing the business; we increased business with existing customers, added channel partners to reach additional customers and looked to Original Equipment Manufacturer (OEM) partners in order to provide full turnkey solutions to the market place. Our sales force is located throughout the United States and calls directly on our National Carrier customers, as well as providing local sales support to our manufacture representatives and Value Added Resellers (VARs). Our go to market model includes a National Account focus driving new product introductions, product standardizations and approvals as well as positioning PECO II and developing relationships throughout the customer's corporate group that provide us visibility and opportunity to expand our relationships. Our regional sales efforts focus on growing business geographically and increasing our presence in those regions.

VARs and manufactures representatives are utilized as both a channel to Tier II and III customers, as well as to augment our overall account and market strategy. Distributors are utilized to support the local needs of our customer base as required. This channel supports local carriers and installation groups who have established purchasing practices with the local branch.

Marketing and Product Line Management are located at our headquarters in Ohio and are responsible for all pricing, promotion, and the coordination of all next generation product and services offerings. We identify product needs from the marketplace through feedback from our customers, our sales personnel, in house engineering staff, and services managers, as well as our strategic partners. We actively participate in industry trade shows as required to communicate to our target market.

Customers

We continue our long history of being a primary DC power solution supplier of product and services to the North American telecommunication marketplace. Our diverse portfolio of customer solutions and long standing reputation allow us to participate in capital deployment projects within all the North American telecommunication market segments such as RBOCs, Independent Telephone Operators, Inter-exchange Carriers, Competitive Access Providers, Original Equipment Manufacturers, Wireless, Cable TV, and Government.

In 2009, the wireless carriers provided us with 55% of our revenue. The major portion of this revenue came from manufactured products (power systems and outside plant cabinets), however, we continue to see an increasing demand and corollary growth with our services portfolio (engineering, installation, maintenance contracts, site audits, and training). We provide aforementioned services to companies such as: Sprint Nextel, Verizon Wireless and AT&T. Note that Alltel was acquired by Verizon Wireless and Centennial Wireless was acquired by AT&T in 2009.

The RBOCs made up 35% of our 2009 revenue. Major customers that we serve in this segment include: AT&T, Verizon and Qwest. This segment grew dramatically in 2009 as a result of the growth in our E&I services capability.

The remaining revenue comes from a large number of other customers that can be classified as Independent Telephone Companies, Competitive Access Providers, Inter-exchange Carriers, Government, Original Equipment Manufacturers, Cable TV, as well as international partners/service providers. This market made up 10% of our revenues in 2009. This segment included a healthy mix of services along with our traditional manufactured products. Some of the customers included in this segment of our customer base include: Level 3, Time Warner Telephone, Nokia and BT.

Backlog

As of December 31, 2009, the unshipped customer order backlog totaled $2.9 million, compared to $2.5 million as of December 31, 2008. We expect to ship the entire December 31, 2009 backlog in 2010.

Operations and Quality Control

The goal of our operations is to be recognized as a world class entity as measured by total customer satisfaction. We strive to achieve complete customer satisfaction by providing customers with zero defects in our installed equipment from product design to test and turn up, all at the best possible value. Our manufacturing operations are focused on factory flow, productivity improvement, cost reduction and evaluation of operations processes to ensure our long-term success. Our services capabilities are focused on zero defects and flawless on-time delivery of our services to meet the requirements of our customers. Likewise, through the development and deployment of quality process tools throughout PECO II, we aim to dramatically improve processes and associate involvement in our quest for excellence. By accomplishing the above, we aim to position PECO II to ensure customer satisfaction, which will enhance our ability to grow our business.

Our primary focus is to deliver our products on time and defect-free, using processes that are designed with employee involvement and focused manufacturing cell principles. Our facility in Galion, Ohio is TL9000 and ISO9001 certified

for quality assurance in design and manufacturing. TL9000 is a specific set of requirements for the telecommunications industry that is based on ISO9001 and developed by the Quest Forum. Our quality policy is a vital ingredient in the daily operations of all associates. Our quality values are based on trust, respect and teamwork. We are committed to continually improve and review our quality management system such that our services and products exceed our customers' needs and expectations every time. In conjunction with the TL9000 / ISO9001 standards, our cross-functional teams are focused to provide our customers with products that meet or exceed industry standards such as Underwriters Laboratories (UL), Canadian Safety Agency (CSA), European Conformity (EC), and the Network Equipment Building Standards (NEBS™).

We have valuable customer relationships, product knowledge, systems integration, and services expertise. We believe that people, both customers and employees, are the most important part of our business. Because we have personnel, as well as manufacturing facilities, in Galion, Ohio with a high level of industry knowledge, we are able to provide our customers with fast and flexible responses to their requirements for products, systems integration, and services.

Research, Development and Engineering

Our engineering efforts are focused on system design, integration and development. We utilize our knowledge of customer applications, safety and network compliance, and system level packaging to create products that meet both general and customer-specific needs. The focus on systems level design and integration allows us to design systems around different power conversion modules to meet specific customer needs. We actively participate in industry standards organizations, and design our products to meet those standards.

Patents and Trademarks

We use a combination of patents, trade secrets, trademarks, copyrights, and nondisclosure agreements to establish and protect our proprietary rights. We cannot assure that any new patents will be issued and that we will continue to develop proprietary products or technologies that are patentable. We also cannot assure that any issued patent will provide us with competitive advantages and will not be challenged by third parties. And finally, we cannot assure that the patents of others will not have a material adverse effect on our business and operating results.

Suppliers and Raw Materials

Our suppliers of metal parts, cable assemblies, electrical components, modules and other sub-assemblies, are vital to our success. We continue to build on our current relationships and to cultivate new suppliers to ensure that we achieve advantageous product costs and improved delivery times that will make us more cost competitive in the marketplace. Cost improvements are achieved through advanced planning with the key suppliers to ensure materials are purchased at optimum quantities and by improving the overall supply chain cycle time from raw materials to finished assemblies and/or sub-assemblies. This will provide opportunities to better respond to customer needs, to provide quality products, and meet the ever-increasing demands for short delivery intervals.

We rely on relationships with some of our competitors to access critical rectifier and converter technology for our power systems. Without access to this critical technology our ability to grow or maintain our current levels of revenue and earnings could be impaired.

Competition

Competition in the global marketplace is served by a number of local and global DC power organizations. These organizations can be broken down into full service providers, discount vendors, and new age vendors. Many of our competitors have more engineering, manufacturing, marketing, financial, and personnel resources than us. We will continue to see disruption in this market space as competitors face the increasing challenges of a shrinking customer base with significantly larger buying power. We believe we will be successful in competing with other similar suppliers based on our long-term customer relationships, our flexibility to scale and respond to customer and market changes, our delivery and services capabilities, our ability to contain costs, and our price, reliability, and quality of product and services.

There are three full service vendors in North America: we are one of the three and Emerson and Lineage are the other two. Telecom carriers who utilize these full service vendors are looking for organizations that have a complete product portfolio, installation and services capabilities, as well as efficient and competitive cost structures. The full service vendors maintain the majority of the market share of the traditional telephone carrier organizations such as the RBOCs, Inter-exchange Carriers, as well as the large incumbent telephone organizations. In addition to the traditional carriers, these full service organizations also dominate the large Tier I wireless providers. Recognition and acceptance as a full service DC power vendor generally requires a long history of top customer relationships, as well as a large embedded base.

In addition to the full service vendors, the North American marketplace is also made up of OEM DC power organizations as well as local and regional niche players. The OEM DC power organizations generally have strong relationships with the top radio manufacturers and integration organizations that allow them to participate in the wireless marketplace via indirect channels. These organizations generally compete on price alone or have a unique offering for a particular application.

Environmental Matters

We are subject to comprehensive and changing foreign, federal, state and local environmental requirements, including those governing discharges to the air and water, the handling and disposal of solid and hazardous wastes and the remediation of contamination associated with releases of hazardous substances. We believe we are in compliance with current environmental requirements. Nevertheless, we use hazardous substances in our operations and, as is the case with manufacturers in general, if releases of hazardous substances occur on or from our properties, we may be held liable and may be required to pay the cost of remedying the condition. The amount of any resulting liability could be material.

Employees

We presently have approximately 190 full-time employees. None of our employees are represented by a labor union. We have not experienced employment related work stoppages.

Additional Information

We make available on our website, www.peco2.com, links to our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and any amendments thereto, as well as proxy statements and other filing with the Securities and Exchange Commission. In addition, copies of our filings can be requested, free of charge, by writing to: Investor Relations, PECO II, Inc., 1376 State Route 598, Galion, Ohio 44833.

ITEM 1A—RISK FACTORS

Failure to consummate the announced merger with Lineage may adversely affect the market price of our common stock and our results of operations.

If the merger is not completed, the price of our common stock may decline to the extent that the current market price reflects a market assumption that the merger will be completed. In addition, in response to the announcement of the merger, our customers and strategic partners may delay or defer decisions which could have a material adverse effect on our business regardless of whether the merger is ultimately completed. Similarly, current and prospective employees of our company may experience uncertainty about their future roles with the combined company. These conditions may adversely affect employee morale and our ability to attract and retain key management, sales, marketing and technical personnel. In addition, focus on the merger and related matters have resulted in, and may continue to result in, the diversion of management's attention and resources. To the extent that there is uncertainty about the closing of the merger, or if the merger does not close, our business may be harmed if customers, strategic partners or others believe that they cannot effectively compete in the marketplace without the merger or if there is customer and employee uncertainty surrounding the future direction of the company on a stand-alone basis.

If the merger does not occur, we will not benefit from the expenses we have incurred in preparation for the merger.

If the merger is not consummated, we will have incurred substantial expenses for which no ultimate benefit will have been received by us. We currently expect to incur significant out-of-pocket expenses for services in connection with the merger, consisting of financial advisor, legal and accounting fees and financial printing and other related charges, many of which may be incurred even if the merger is not completed. Moreover, under specified circumstances, we may be required to pay a termination fee of $1.1 million, depending upon the reason for termination, to Lineage in connection with a termination of the merger agreement.

Legal proceedings in connection with the merger could delay or prevent the completion of the merger.

A purported class action lawsuit has been filed by third parties challenging the proposed merger and seeking, among other things, to enjoin the consummation of the merger. One of the conditions to the closing of the merger is that no order shall have been issued by any court of competent jurisdiction preventing the consummation of the merger. If a plaintiff is successful in obtaining an injunction prohibiting consummation of the merger, then the injunction may delay the merger or prevent the merger from being completed.

The communications market fluctuates and is impacted by many factors, including decisions by service providers regarding capital expenditures and their timing of purchases as well as demand and spending for communications services by businesses and consumers.

After significant deterioration earlier this decade, the global communications market stabilized in 2004 and experienced modest growth through 2008, as reflected in increased capital expenditures by service providers and growing demand for telecommunications services. In 2009, the overall market was flat to down, primarily resulting from the ongoing industry level consolidation that continues amongst the service providers combined with the overall

economic conditions. Although we believe the overall market will continue to grow, the rate of growth could vary and is subject to substantial fluctuations, especially in times of overall economic uncertainty. Additionally, the specific market segments in which we participate may not experience the growth of other segments. If this were to continue to occur, or if there was a reduction in capital expenditures, our business, operating results, and financial condition may be adversely affected. If capital investment by service providers grows at a slower pace than we anticipate, our business, operating results and financial condition may be adversely affected. The level of demand by service providers can change quickly and can vary over short periods of time, including from month to month.

A small number of customers account for a high percentage of our net sales; there are only a small number of potential major customers in our primary market; and the loss of a key customer could have a negative impact on our operating results and cause our stock price to decline.

In any one quarter, it is typical for us to have two to three key customers that each account for over 10% of our revenues. In 2009, sales to our ten largest customers accounted for approximately 85.3% of net sales. We expect that we will continue to be dependent upon a limited number of customers for a significant portion of our revenues in future periods. In addition, almost all of our sales are made on the basis of purchase orders, and most of our customers are not obligated to purchase products or services from us. As a result of this customer concentration, our revenues and operating results may be materially adversely affected by the failure of anticipated orders to materialize or by deferrals or cancellations of orders. In addition, there can be no assurance that revenue from customers that accounted for significant sales in past periods, individually, or as a group, will continue, or if continued, will reach or exceed historical levels in any future period. Further, such customers are concentrated in the communications industry and our future success depends on the capital spending patterns and the continued demand of such customers for our products and services. Additionally, any merger or acquisitions among our customers could impact future orders from such customers.

If we are unable to meet our additional capital needs in the future, we may miss expansion opportunities or find ourselves unable to respond to actions by our competitors, which could impair our competitive position and hurt sales and earnings.

In the future, our competitive position could be impaired if we cannot raise capital when required and therefore we would not be able to take advantage of opportunities to expand our business either internally or through acquisitions. Our sales and earnings could suffer if we do not have the financial resources needed to respond to new product introductions or market price erosion. If additional funds are raised through the issuance of equity securities, the percentage ownership of our then-current shareholders may be reduced and such equity securities may have rights, preferences, or privileges senior to those of our common shareholders. In addition, there can be no assurance that additional financing will be available at favorable terms or will be available at all. If adequate funds are not available or not available on acceptable terms we may not be able to take advantage of unanticipated opportunities, develop new or enhanced services and related products, or otherwise respond to unanticipated competitive pressures. Our business, operating results, and financial condition could be materially adversely affected without additional capital.

We may fail to meet market expectations because of fluctuations in our quarterly operating results, which could cause our stock price to decline.

Our quarterly operating results have significantly varied in the past and will continue to do so in the future depending on factors such as the timing of significant orders and shipments; capital spending patterns of our customers; changes in the regulatory environment; changes in our pricing or the pricing of our competitors; increased competition; mergers and acquisitions among customers; personnel changes; demand for our products; the number, timing, and significance of new product and product enhancement announcements by us and our competitors; our ability to develop, introduce, and market new and enhanced versions of our products on a timely basis; and the mix of direct and indirect sales and general economic factors. A significant portion of our revenues have been, and will continue to be, derived from substantial orders placed by large organizations, such as the Tier I wireless providers, and the timing of such orders and their fulfillment has and will cause material fluctuations in our operating results, particularly on a quarterly basis. Due to the foregoing factors, quarterly sales and operating results have been and will continue to be difficult to forecast. Based upon all of the foregoing, we believe that quarterly sales and operating results are likely to vary significantly in the future and period-to-period comparisons of our results of operations are not necessarily meaningful and should not be relied upon as indications of future performance. Further, it is likely that in some future quarter, our sales or operating results will be below the expectations of public market analysts and investors. In such

event, the price of our common stock could be materially adversely affected.

If we engage in acquisitions, we may experience difficulty assimilating the operations or personnel of the acquired companies, which could threaten the benefits we seek to achieve through acquisitions and our future growth.

If we make additional strategic acquisitions, we could have difficulty assimilating or retaining the acquired companies' personnel or integrating their operations, equipment, or services into our organization. This could disrupt our ongoing business, distract our management and employees, and reduce or eliminate the financial or strategic benefits that we sought to achieve through the acquisition and threaten our future growth.

Equipment problems may seriously harm our credibility and have a significant impact on our revenues, earnings and growth prospects.

Communications service providers insist on high standards of quality and reliability from communications equipment suppliers. If we deliver defective equipment, if our equipment fails due to improper maintenance, or if our equipment is perceived to be defective, our reputation, credibility and equipment sales could suffer. Any of these consequences could have a serious effect on our sales, earnings and growth prospects.

We will not remain competitive if we cannot keep up with a rapidly changing market.

The market for the equipment and services we provide is characterized by rapid technological changes, evolving industry standards, changing customer needs and frequent new equipment and service introductions. Failure to keep up with these changes could impair our competitive position and hurt sales, earnings and our prospects for future growth. If we fail to adequately predict and respond to these market changes, our existing products or products in development could become obsolete in a relatively short time frame. Our future success in addressing the needs of our customers will depend, in part, on our ability to timely and cost-effectively:

§ respond to emerging industry standards and other technological changes;

§ develop our internal technical capabilities and expertise;

§ broaden our equipment and service offerings; and

§ adapt our products and services to new technologies as they emerge.

The need for our products to obtain certification and the high demand for lab time could reduce our revenue and earnings by impairing our ability to bring new products to markets.

Typically, our products must be compliant with and certified by certain certifying agencies and bodies, including the Underwriters Laboratories, Canadian Safety Agency, European Conformity and, more recently, the Network Equipment Building Standard. Certification typically requires a company to secure lab time to perform testing on the equipment to be certified. The time required to obtain approvals from certifying bodies may result in delays in new product introductions, which could delay or reduce anticipated revenue and earnings from those products.

We could lose revenue opportunities if we do not decrease the time it takes us to fill our customers' orders.

A customer's selection of power equipment is often based on which supplier can supply the requested equipment within a specified time period. Unless we increase our manufacturing capacity to meet the increasingly shortened delivery schedules of our customers, we may lose potential sales from existing or new customers.

The market for supplying equipment and services to communications service providers is highly competitive, and, if we cannot compete effectively, our ability to grow our business or even to maintain revenues and earnings at current levels, will be impaired.

Competition among companies that supply equipment and services to communications service providers is intense. A few of our competitors have significantly greater financial, technological, manufacturing, marketing and distribution resources than we do. There can be no assurance that our current or potential competitors will not develop products comparable or superior to those developed by us or adapt more quickly than us to new technologies, emerging industry trends or changing customer requirements. Increased competition may cause us to lose market share or

compel us to reduce prices to remain competitive, which could result in reduced gross margins. Additionally, we rely on relationships with some of our competitors to access critical rectifier and converter technology for our power systems. Without access to this critical technology, our ability to grow or to even maintain our current levels of revenues and earnings could be impaired.

A significant downturn in the general economy could adversely affect our revenue, gross margin, and earnings.

Our business could be unfavorably affected by changes in national or global economic conditions, including inflation, interest rates, availability of capital markets, consumer spending rates, and the effects of governmental plans to manage economic conditions. The demand for many of our products and services is strongly correlated with the general economic conditions and with the level of business activity of our customers. Economic weakness and constrained customer spending has resulted in the past, and may result in the future, in decreased revenue, gross margin, earnings, or growth rates. We also have experienced, and may experience in the future, gross margin declines reflecting the effects of increased pressure for price concessions as our customers attempt to lower their cost structures. In this environment, we may not be able to reduce our costs sufficiently to maintain our margins.

Our products are dependent in part upon our proprietary technology.

Our ability to compete is dependent in part upon our proprietary technology. We rely on a combination of patents, trade secrets, copyright and trademark laws, nondisclosure and other contractual agreements, and technical measures to protect our proprietary rights. Despite our efforts to protect these rights, unauthorized parties may attempt to copy aspects of our products or to obtain and use the information that we regard as proprietary. There can be no assurance that the steps we take to protect our proprietary information will prevent misappropriation of such technology and such protections may not preclude competitors from developing products with functionality or features similar to our products. While we believe that our products and trademarks do not infringe upon the proprietary rights of third parties, there can be no assurance that we will not receive future communications from third parties asserting our products infringe, or may infringe, the proprietary rights of third parties. Any such claims could be time-consuming, result in costly litigation and diversion of technical and management personnel, cause product shipment delays, or require us to develop non-infringing technology or enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to us or at all. In the event of a successful claim of product infringement against us, if we fail or are unable to develop non-infringing technology or license the infringed or similar technology, our business, operating results and financial condition could be materially adversely affected.

Failure to attract and retain qualified personnel may result in difficulties in managing our business effectively and meeting revenue growth objectives.

Our success in efforts to grow our business depends on the contributions and abilities of key personnel, executives, operating officers, and others. If we are unable to retain and motivate our existing employees and attract qualified personnel to fill key positions, we may not be able to manage our business effectively, including the development of both existing and new products and services. Success in meeting our revenue and margin objectives also depends in large part on our ability to attract, motivate, and retain highly qualified personnel in sales and information management positions. Competition for such personnel is intense and there can be no assurance that we will be successful in attracting, motivating, and retaining such personnel. Any inability to hire and retain salespeople or any other qualified personnel, or any loss of the services of key personnel, could harm our business.

There is a limited market for trading in our common shares and our stock price has been volatile.

Although we are listed on the Nasdaq Capital Market, there can be no assurance that an active or liquid trading market in our common shares will continue. The market price of our common shares is likely to be volatile and may be significantly affected by factors such as actual or anticipated fluctuations in our operating results; announcements of technological innovations, new products or new contracts by us or our competitors; developments with respect to copyrights or proprietary rights; general market conditions; and other factors.

Although our common shares are currently in compliance with The Nasdaq Stock Market’s continued listing standards, we cannot assure you that we will be able to maintain such compliance in the future.

From February 13, 2007, to May 22, 2008, we were not in compliance with The Nasdaq Stock Market’s Marketplace Rule that requires the Company to maintain a $1.00 per share minimum bid price. In an effort to regain compliance, our shareholders approved, and on May 7, 2008, we executed a 1-for-10 reverse stock split. On May 22, 2008, we received a decision that Nasdaq would continue the listing of our common shares on The Nasdaq Stock Market. Although our common shares are currently in compliance with the Nasdaq Stock Market’s continued listing standards, we cannot assure you that we will continue to meet all continued listing standards in the future.

Ownership of our common shares is concentrated among a few shareholders, who may be able to exert substantial influence over our Company.

Our present officers and directors own outright approximately 20.7% of our common shares as of March 12, 2010. In particular, Messrs. Matthew P. Smith and James L. Green, and their respective affiliates, own outright approximately 16.9% of our common shares as of March 12, 2010. In addition, Delta International Holding Ltd. owns outright 474,037 shares or approximately 16.6% of our common shares as of March 12, 2010. As a result, these shareholders have the potential to exercise significant influence over matters requiring shareholder approval, including the election of directors and approval of significant corporate transactions. Such ownership may have the effect of delaying or preventing a change in control of our Company.

We may be subject to certain environmental and other regulations.

Some of our operations use substances regulated under various federal, state, local and international environmental and pollution laws, including those relating to the storage, use, discharge, disposal and labeling of, and human exposure to, hazardous and toxic materials. Compliance with current or future environmental laws and regulations could restrict our ability to expand our facilities or require us to acquire additional expensive equipment, modify our manufacturing processes or incur other significant expenses. In addition, we could incur costs, fines and civil or criminal sanctions, third party property damage or personal injury claims or could be required to incur substantial investigation or remediation costs, if we were to violate or become liable under any environmental laws. Liability under environmental laws can be joint and several and without regard to comparative fault. There can be no assurance that violations of environmental laws or regulations have not occurred in the past and will not occur in the future as a result of our inability to obtain permits, human error, equipment failure or other causes, and any such violations could harm our business and financial condition.

There are inherent limitations in all control systems, and misstatements due to error or fraud may occur and not be detected.

While we continue to take action to ensure compliance with the disclosure controls and other requirements of the Sarbanes-Oxley Act of 2002 and the related Securities and Exchange Commission and Nasdaq rules, there are inherent limitations in our ability to control all circumstances. There is no guarantee that our internal controls and disclosure controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. In addition, the design of a control system must reflect the fact that there are resource constraints and the benefit of controls must be evaluated in relation to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, in our company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Further, controls can be circumvented by individual acts of some persons, by collusion of two or more persons, or by management override of the controls. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, a control may be inadequate because of changes in conditions or the degree of compliance with the policies or procedures may deteriorate. Because of inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

ITEM 1B—UNRESOLVED STAFF COMMENTS

None.

ITEM 2—PROPERTIES

The following table sets forth certain information about our principal facilities:

Location	Approximate Square Feet	Uses	Owned/Leased
Galion, Ohio (A)	285,375	Principal executive and corporate office, sales and services office, and manufacturing and assembly	Owned

Canton, Georgia	12,343	Engineering, installation services and sales office	Leased

(A) Includes the Galion, Ohio corporate office shell, which is listed for sale, 42,000 square feet.

We have continued to narrow our excess capacity for our current operations and continue to attempt to sell or lease the Galion, Ohio, corporate office shell.

Our current capacity, with limited capital additions, is expected to be sufficient to meet production requirements for the near future. We believe our production facilities are suitable and can meet our future production needs.

ITEM 3—LEGAL PROCEEDINGS

We are party to legal proceedings and litigation arising in the ordinary course of business. Although the outcome of such items cannot be determined with certainty, management is of the opinion that the final outcome of these matters should not have a material effect on our results of operations or financial position.

The Company, each of the members of the Company's board of directors, Lineage Power Holdings, Inc. ("Lineage"), and Lineage Power Ohio Merger Sub, Inc. ("Merger Sub") were named defendants in a purported class action and shareholder derivative lawsuit filed in the Court of Common Pleas of Cuyahoga, County, Ohio, on or about March 5, 2010, and styled as follows: Harshad Sandesara v. PECO II, Inc., et al., Case No. CV 10 720332. Plaintiff is a shareholder of the Company and seeks both to enjoin the merger and damages. On March 15, 2010, plaintiff filed an amended complaint and a motion for expedited proceedings. Thereafter, on March 19, 2010, plaintiff filed a motion for preliminary injunction asking that the court block the merger. The lawsuit alleges, among other things, that the directors of the Company, aided and abetted by the Company and Lineage, breached their fiduciary duties in connection with the directors' recommendation that the shareholders adopt a proposed merger transaction between the Company and Merger Sub that would result in the Company being a wholly owned subsidiary of Lineage. On March 25, 2010, the defendants filed a motion to dismiss the amended complaint and a brief in opposition to the motion for expedited proceedings. On March 26, 2010, the Court denied plaintiff's motion to expedite discovery and ordered the Company to supplement its proxy statement filed March 18, 2010 with specific information concerning the background of the merger. At this stage, it is not possible to predict the outcome of this proceeding or its impact on the Company. The Company believes the allegations made in the amended complaint are without merit and intends to vigorously defend against the plaintiff's claims.

ITEM 4—(REMOVED AND RESERVED)

PART II

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

Market Information

Our common shares began trade on the Nasdaq Capital Market under the symbol "PIII." The following table sets forth the high and low sales prices (on a post-split basis) of our common shares on the Nasdaq Capital Market for the periods set forth below:

2009	High	Low
First Quarter	$ 4.25	$ 2.39
Second Quarter	$ 4.75	$ 2.40
Third Quarter	$ 4.29	$ 2.58
Fourth Quarter	$ 5.20	$ 2.89
2008		
First Quarter	$ 7.60	$ 5.50
Second Quarter	$ 8.50	$ 3.12
Third Quarter	$ 4.85	$ 3.28
Fourth Quarter	$ 4.44	$ 2.04

Holders

As of March 16, 2010, there were 496 holders of record of our common shares.

Dividends

We have not paid any dividends since our initial public offering in August 2000. We do not currently plan to pay dividends. Any future determination to pay dividends will be at the discretion of the board of directors and will depend upon our financial condition, operating results, capital requirements and other factors the board of directors deems relevant.

Performance Graph

Not required for smaller reporting companies.

Recent Sales of Unregistered Securities

During the fourth quarter of 2009, no unregistered securities were sold.

Purchases of Equity Securities by the Issuer and Affiliated Purchases

During the fourth quarter of 2009, no repurchases were made.

ITEM 6—SELECTED FINANCIAL DATA

Not required for smaller reporting companies.

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

You should read this discussion together with the consolidated financial statements and other financial information elsewhere in this Form 10-K.

Overview

PECO II, Inc. was organized in 1988 for the purpose of acquiring the assets of ITT's communications power product business. Today, we provide solutions to our telecommunications customers through a variety of products and services in order to meet their cost, quality, productivity and capacity challenges. As part of this process, we design and manufacture communications specific power products. We also provide on-site engineering and installation, systems integration, installation, maintenance, and monitor services to our customers. Our power systems provide a primary supply of power to support the infrastructure of communications service providers, including local exchange carriers, long distance carriers, wireless service providers, internet service providers and broadband access providers. Our power distribution equipment directs this power to specific customer communications equipment. Our systems integration business provides complete built-to-order communications systems assembled and installed pursuant to customer specifications and incorporating other manufacturers' products.

Market conditions remain uncertain and difficult. In the recent past, several of our customers have engaged in mergers, acquisitions and divestitures, such as SBC acquiring AT&T, AT&T acquiring Bell South and Cingular, Alltel acquiring Western Wireless, and Sprint acquiring NEXTEL. Also, both Sprint Nextel and Alltel spun off their local wireline businesses to focus on their core wireless businesses. Recently Verizon has concluded its purchase of Alltel, AT&T has concluded its purchase of Centennial, and Century Tel has merged with Embarq to form CenturyLink. Currently, major wireline companies are focusing their capital expenditure spending on FTTC (fiber to the curb) and FTTN (fiber to the node) for both broadband and video services distribution, while wireless companies are focusing their capital expenditure spending on migration of acquired systems to the standards of the acquiring carrier, integrating networks, improving area coverage, deploying 3G data services and have begun to announce plans to deploy WIMAX and LTE networks.

While the telecommunications market is extremely volatile, estimated capital expenditure spending was flat to down in 2009 and analysts, given the economic uncertainty, are unsure regarding capital expenditure levels for 2010. The current economic environment is causing many companies to forecast flat to limited growth in spending in the near

future. Notwithstanding this possible ongoing slowdown, we believe that our capabilities, combined with our market position, will afford us the opportunity to take market share even in a slowing economy.

In 2009, we targeted the capital expenditures growth in the wireless market and services spending. We successfully maintained our market position with key customers notwithstanding a downturn in 2009 product revenues. We believe that the downturn in product revenues was primarily driven by reduced spending due to the industry consolidation that occurred in 2009.

Our R&D investment extended beyond traditional cell site applications. Our small product platforms are the QuantumTM Power System and the MPS Micro Power System. The Quantum platform is a 48-volt DC power system that combines high-density rectifiers, distribution and control in a sleek, low-profile shelf. It is optimized for telecom carriers deploying FTTN and traditional wireline architectures. Designed for the harsh outside plant environment, the Quantum system's small footprint makes it ideal for cabinets where rack space is at a premium. Both 23" and 19" Integrated Shelves were developed in 2008, along with a variety of distribution options. The Quantum system has achieved NEBS Level 3 certification.

The MPS Micro Power System, is a small power system designed for the network edge. Depending on configuration, the low profile system supplies anywhere from 18 Amps to 150 Amps of current at 48Vdc in a 1RU shelf by 19" wide shelf. The system contains up to three rectifiers, integrated distribution and a system controller. The controller provides standard DC power system management along with battery management, as well as an optional SNMP interface. Integrated distribution can include GMT fuses and a battery disconnect fuse, minimizing the size of the overall system and making it ideal for use in space-constrained remote cabinet applications. A primary application for the MPS is powering triple play solutions for multiple dwelling unit applications. We began customer trials during the fourth quarter of 2008.

During the fourth quarter of 2009, we introduced our next generation midsized power plant products to the marketplace. These next generation 138 and 139 power plants utilize 1RU rectifiers and converters, incorporate a totally redesigned user interface, and implement reconfigured AC input and DC output interconnections. User friendliness, field serviceability, and cable management have all been significantly improved while preserving all tried and true customer practices. The 138 and 139 plants also support the growing number of "green" initiatives by incorporating high efficiency 1RU rectifiers and converters. Customer reaction has been very favorable. Several plants have already shipped to new customers and customers of existing mid-size power plants have expressed strong desire to move to the new power plants.

During the first quarter 2009, we achieved TL9000 recertification. The certification process included evaluation of our core business processes based on TL9000 Quality Management System Requirements Release 4.0, an upgrade over previous assessments. The TL9000 standard defines the telecommunications quality system requirements for the design development, production, delivery, installation and maintenance of products and services.

Our Services group focused on hardening our solution portfolio to meet the power needs of our Tier I customer base. The revenue decline in 2008 was driven by reduced spending at two of our major customers. During the fourth quarter of 2008, we were notified of a contract renewal with a major Tier I customer. This renewal included a major expansion of work to be performed by us. This contract award was the primary driver for our 2009 revenue growth.

Our Services division continues to provide multi-vendor E&I services for all major power product brands. This capability is both respected and valued in the marketplace. Our strong power E&I services reputation has provided many opportunities for introducing new power products as well as a real user feedback channel on deployed products. This feedback continues to aid us with designing and improving products to meet the industry evolving needs.

Looking forward, we will continue to focus our efforts on delivering the service solutions our customers have come to expect from working with PECO II. This dedication has enabled us to minimize customer turnover. We will continue to expand our Services footprint on those opportunities that make the best utilization of our current available resources, and/or those that position us for success as our industry matures to the next level.

Critical Accounting Policies and Estimates

In preparing our financial statements and accounting for the underlying transactions and balances, we applied the accounting policies disclosed in the Notes to the Consolidated Financial Statements. Preparation of our financial statements requires us to make estimates and assumptions that affect the reported amount of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Although we believe our estimates and assumptions are reasonable, they are based on information presently available and actual results may differ significantly from those estimates.

We consider the estimates discussed below as critical to an understanding of our financial statements because they place the most significant demands on management's judgment about the effect of matters that are inherently uncertain, and the impact of different estimates or assumptions is material to our financial condition or results of operations. Specific risks for these critical accounting estimates are described in the following paragraphs. The impact and any associated risks related to these estimates are discussed throughout this discussion and analysis where such estimates affect reported and expected financial results.

For a detailed discussion of the application of these and other accounting policies, see Note 1 to the Consolidated Financial Statements. Management has discussed the development and selection of the critical accounting policies and the related disclosure included herein with the Audit Committee of the Board of Directors.

Revenue Recognition

Product revenues are recognized when customer orders are completed and shipped, title passes to the customer and collection is reasonably assured. Product sales sometimes include multiple items including services such as installation. In such instances, product revenue is not recognized until installation is complete and the product is made available for customer use. Services revenues on E&I contracts and the costs for services performed are primarily recorded as the work progresses on a percentage of completion basis. Management believes that all relevant criteria and conditions are considered when recognizing sales.

Impairment of Long-Lived Assets

We assess the impairment of long-lived assets, which include intangible assets and plant and equipment, whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors considered important that could trigger an impairment review include, but are not limited to, the following:

- Sustained underperformance relative to expected historical or projected future operating results;
- Changes in the manner of use of the assets, their physical condition or the strategy for the Company's overall business;
- Negative industry or economic trends;
- Declines in stock price of an investment for a sustained period;
- The Company's market capitalization relative to net book value;
- A more-likely-than-not expectation that a reporting unit or a significant portion of a reporting unit, or a long-lived asset will be sold or otherwise disposed of, significantly before the end of its previously estimated useful life;
- A significant decrease in the market price of a long-lived asset;
- A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset, including an adverse action or assessment by a regulator;
- An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset;
- A current period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset;
- Unanticipated competition; and
- A loss of key personnel.

Inventory Valuation

Inventories are stated at the lower of cost or market with cost determined on a standard cost basis that approximates the first-in, first-out method. Inventory costs consist of purchased product, internal and external manufacturing costs, and freight. Management regularly reviews inventory for obsolescence or excessive quantities and records an allowance accordingly. Various factors are considered in making this determination, including recent usage history, forecasted usage and market conditions.

We continually review the inventory for obsolescence or excessive quantities and accrue accordingly. At a minimum, all part numbers are reviewed quarterly. We identify potential obsolete or excess inventory by identifying parts with no usage for a year and excess parts greater than the last twelve month usage or two times future six month requirements, whichever is greater. Management reviews the inventory identified as potentially obsolete or excess to determine the appropriate allowance.

Deferred Taxes

We record income taxes under the asset and liability method. Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities, and any valuation allowance recorded against our deferred tax assets.

Our ability to realize deferred tax assets is primarily dependent on the future taxable income of the taxable entity to which the deferred tax asset relates. We evaluate all available evidence to determine whether it is more likely than not that some portion or the entire deferred income tax asset will not be realized.

Share-Based Compensation

Determining the appropriate fair value model and calculating the fair value of share-based payment awards require the input of subjective assumptions, including the expected life of the share-based payment awards and stock price volatility. The assumptions used in calculating the fair value of share-based payment awards represent management's best estimates, but these estimates involve inherent uncertainties and the application of management judgment. As a result, if factors change and we use different assumptions, our stock-based compensation expense could be different in the future.

Under the fair value recognition provisions, we recognize stock-based compensation expense net of an estimated forfeiture rate and only recognize compensation expense for those shares expected to vest over the requisite service period of the award. If our actual forfeiture rate is materially different from our estimate, our stock-based compensation expense could be significantly different from what we have recorded in the current period.

Results of Operations

The following table shows, for the periods indicated, selected items and the percentage of net sales from our consolidated statement of operations.

	Year Ended December 31,					
	2009			2008		
Net sales:						
Product	$24,105	57.0	%	$31,554	75.6	%
Services	18,182	43.0	%	10,189	24.4	%
	42,287	100.0	%	41,743	100.0	%
Cost of sales (exclusive of depreciation and amortization):						
Product	18,854	44.6	%	25,549	61.2	%
Services	13,579	32.1	%	8,292	19.9	%
Obsolete inventory write-off	1,035	2.4	%	2,146	5.1	%
	33,468	79.1	%	35,987	86.2	%
Gross margin	8,819	20.9	%	5,756	13.8	%
Operating expenses:						
Depreciation and amortization	1,466	3.5	%	1,494	3.6	%
Research, development and engineering	1,873	4.4	%	2,306	5.5	%
Selling, general and administrative	7,179	17.0	%	8,083	19.3	%
Impairment of goodwill	—	—		1,503	3.6	%
Impairment of idle facility	—	—		200	0.5	%
	10,518	24.9	%	13,586	32.5	%
Loss from operations	(1,699)	(4.0	%)	(7,830)	(18.7	%)
Interest income, net	26	0.1	%	171	0.4	%
Loss before income taxes	(1,673)	(3.9	%)	(7,659)	(18.3	%)
Income tax expense	(14)	(0.1	%)	(45)	(0.1	%)
Net loss	$(1,687)	(4.0	%)	$(7,704)	(18.4	%)

Net Sales. Net sales increased $0.5 million, or 1.3%, to $42.3 million for the year ended December 31, 2009 from $41.7 million for the year ended December 31, 2008. This increase was driven primarily by our services business. Services revenues grew by $8.0 million in 2009. Our E&I capabilities were the major driver of this growth.

Net sales in our product segment decreased by $7.5 million, with the result being $24.1 million for the year ended December 31, 2009 as compared to $31.6 million for the year ended December 31, 2008. We believe this reduction was primarily the result of the industry level consolidation that occurred in 2009 in North America. As of December 31, 2009, our product backlog, which represents total dollar volume of firm sales orders not yet recognized as revenue, had decreased to $1.2 million from $1.9 million at December 31, 2008.

Net sales in our services segment increased by $8.0 million, resulting in $18.2 million for year ended December 31, 2009 as compared with $10.2 million for the year ended December 31, 2008. The increase in revenues was primarily driven by new services work with a major service provider for our E&I capabilities. As of December 31, 2009, our services backlog, which represents total dollar volume of firm sales orders not yet recognized as revenue, had increased to $1.7 million from $0.6 million at December 31, 2008.

Gross Margin. Gross margin dollars increased to $8.8 million in 2009 as compared to $5.8 million in 2008. Gross margin as a percentage of net sales increased to 20.9% in 2009 as compared to 13.8% in 2008. This increase included a charge of $1.0 million for obsolete and slow-moving inventory as compared to a charge of $2.1 million in 2008.

The product gross margin increased to $4.2 million in 2009 as compared to $3.9 million in 2008. Product gross margin, as a percentage of product sales, increased to 17.5% in 2009, compared to 12.2% in 2008. This increase was primarily driven by product price increases instituted in 2009 with a number of our major customers, combined with reduced obsolescence charges, when compared to 2008.

The services segment gross margin increased to $4.6 million in 2009 as compared with the $1.9 million in 2008. Services gross margin as a percentage of services sales was 25.3% in 2009 as compared to 18.6% in 2008. This increase reflected the impact of the services contract win noted above.

Research, Development and Engineering. Research, development and engineering expense decreased to $1.9 million in 2009 from $2.3 million in 2008, representing a decrease of $0.4 million. The decrease was primarily driven by the completion of major small power work that was accomplished in 2008. As a percentage of net product sales, research, development and engineering expense increased to 7.8% in 2009 up from 7.3% in 2008.

Selling, General and Administrative. Selling, general and administrative expense decreased to $7.2 million in 2009 from $8.1 million in 2008, representing a decrease of $0.9 million. As a percentage of net sales, selling, general and administrative expense decreased to 17.0% in 2009 from 19.3% in 2008. The decrease, as a percentage of revenues, reflected the productivity increases realized as we continued our focus on process improvements throughout the business.

Interest Income. Interest income, net, was $26 thousand in 2009 compared to $171 thousand in 2008. Of this amount, interest expense was $18 thousand in 2009 compared to $14 thousand in 2008, while interest income decreased to $44 thousand in 2009 compared to $185 thousand in 2008. The decrease in interest income, net, in the current year was due primarily to less income from investments from reduced interest-earning balances and reductions of effective interest rates.

Income Taxes. As a result of our significant continued operating losses in recent years, we have not been subject to significant income taxes and have a 100% valuation allowance for our net deferred tax assets. As such, our effective income tax rate was a negative 0.8% in 2009 compared to an effective rate of negative 0.6% in 2008.

Liquidity and Capital Resources

Our primary liquidity needs for the foreseeable future will be for working capital and operations. As of December 31, 2009, available cash and cash equivalents approximated $7.4 million. Based on available funds and current plans, we believe that our available cash, borrowings and amounts generated from operations, will be sufficient to meet our cash requirements for the next 12 months. The assumptions underlying this belief include, among other things, that there will be no material adverse developments in the business or market in general. There can be no assurances however that those assumed events will occur. If management’s plans are not achieved, there may be further negative effects on the results of operations and cash flows, which could have a material adverse effect on the Company.

Working capital was $12.2 million at December 31, 2009, which represented a working capital ratio of 2.6 to 1, compared to $12.4 million at December 31, 2008. Our investment in inventories and accounts receivables was $11.3 million and $12.9 million at December 31, 2009 and 2008, respectively. Our capital expenditures were $0.2 million and $0.07 million in 2009 and 2008, respectively. Our budgeted capital expenditures for 2010 are $0.1 million as we remain focused on conserving cash. Accounts receivable days sales outstanding stood at 46 days at December 31, 2009, as compared to 46 days at December 31, 2008. At December 31, 2009, inventory days on hand, which represents gross inventory excluding impairments or reserves, was 152 days, as compared to 145 days on hand at December 31, 2008.

Cash flows provided by operating activities were $2.7 million in 2009, compared to 2008 which had cash flows used for operating activities of $3.0 million. This was primarily from a reduced net loss of $6.0 million compared to 2008, decreases in inventory and other non-cash charges offset by increases in accounts receivable and other assets. There was $671 thousand of cash provided by investing activities, which was primarily from reduction in restricted cash offset by capital expenditures. Cash used for financing activities was $1.8 million, which was primarily the result of payoff of line of credit and bank overdraft.

We have an available line of credit agreement with National City Bank for borrowing up to $3.5 million. The line of credit requires certain amounts be restricted in an identified collateral account based on the outstanding balance due. As of December 31, 2009, there is an outstanding balance of $0 on the line of credit. As such, the portion of the deposit account collateralized is reflected as restricted cash in the accompanying balance sheet as of December 31, 2009.

We believe that cash and cash equivalents, anticipated cash flow from operations, and our credit facilities will be sufficient to fund our working capital and capital expenditure requirements for at least the next 12 months. We do not currently plan to pay dividends.

From February 13, 2007, to May 22, 2008, we were not in compliance with The Nasdaq Stock Market's Marketplace Rule that requires the Company to maintain a $1.00 per share minimum bid price. In an effort to regain compliance, our shareholders approved, and on May 7, 2008, we executed, a 1-for-10 reverse stock split. On May 22, 2008, we received a decision that Nasdaq would continue the listing of our common shares on The Nasdaq Stock Market. Although our common shares are currently in compliance with the Nasdaq Stock Market's continued listing standards, we cannot assure you that we will continue to meet all continued listing standards in the future.

We have operating leases covering certain office facilities and equipment that expire at various dates through 2014. Future minimum annual lease payments required during the years ending in 2010 through 2014 under non-cancelable operating leases having an original term of more than one year are $324 thousand, $191 thousand, $92 thousand, $93 thousand and $47 thousand respectively.

Impact of New Accounting Standards

Recently adopted and recently issued accounting pronouncements and their effects on the Company's consolidated financial statements are described in Note 1, "Summary of Significant Accounting Policies," in Item 8.

Off-Balance Sheet Arrangements

We do not have any off balance sheet entities or arrangements. All of our subsidiaries are reflected in our financial statements. We do not have any interests in or relationships with any special-purpose entities that are not reflected in our financial statements.

ITEM 7A—QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not required for smaller reporting companies.

ITEM 8—FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

PECO II, INC.

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REPORT OF INDEPENDENT REGISTERED
PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders
PECO II, Inc.
Galion, Ohio

We have audited the accompanying consolidated balance sheets of PECO II, Inc. and subsidiaries as of December 31, 2009 and 2008, and the related consolidated statements of operations, shareholders' 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.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of PECO II, Inc. and subsidiaries as of December 31, 2009 and 2008, and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

/s/ BATTELLE & BATTELLE LLP

Dayton, Ohio
March 31, 2010

PECO II, INC.

CONSOLIDATED BALANCE SHEETS
(In thousands, except share data)

	December 31, 2009	2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 7,394	$ 5,814
Accounts receivable, net	5,786	4,366
Inventories, net	5,470	8,533
Cost and earnings in excess of billings on uncompleted contracts	1,158	622
Prepaid expenses and other current assets	166	295
Restricted cash	-	834
Total current assets	19,974	20,464
Property and equipment, at cost:		
Land and land improvements	195	195
Buildings and building improvements	4,628	4,628
Machinery and equipment	3,031	2,895
Furniture and fixtures	5,538	5,518
	13,392	13,236
Less-accumulated depreciation	(10,471)	(10,109)
Property and equipment, net	2,921	3,127
Other assets:		
Idle facility	800	800
Intangibles, net	1,675	2,748
Total assets	$ 25,370	$ 27,139
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Borrowings under line of credit	$ -	$ 834
Bank overdrafts	-	994
Accounts payable	3,308	3,387
Billings in excess of cost and estimated earnings on uncompleted contracts	1,135	235
Accrued compensation expense	1,535	923
Accrued income taxes	36	56
Other accrued expenses	1,739	1,633
Total current liabilities	7,753	8,062
Shareholders' equity:		
Common stock, no par value: 150,000,000 shares authorized; 2,851,385 and 2,816,527 shares issued at December 31, 2009 and 2008, respectively	3,617	3,573
Additional paid-in capital	122,085	121,901
Accumulated deficit	(108,085)	(106,397)
Total shareholders' equity	17,617	19,077
Total liabilities and shareholders' equity	$ 25,370	$ 27,139

The accompanying notes are an integral part of these consolidated balance sheets.

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PECO II, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)

	Years Ended December 31,	
	2009	2008
Net sales:		
Product	$ 24,105	$ 31,554
Services	18,182	10,189
	42,287	41,743
Cost of sales (exclusive of depreciation and amortization):		
Product	18,854	25,549
Services	13,579	8,292
Obsolete inventory write-off	1,035	2,146
	33,468	35,987
Gross margin	8,819	5,756
Operating expenses:		
Depreciation and amortization	1,466	1,494
Research, development and engineering	1,873	2,306
Selling, general and administrative	7,179	8,083
Impairment of goodwill	—	1,503
Impairment of idle facility	—	200
	10,518	13,586
Loss from operations	(1,699)	(7,830)
Interest income, net	26	171
Loss before income taxes	(1,673)	(7,659)
Income tax expense	(14)	(45)
Net loss	$ (1,687)	$ (7,704)
Net loss per common share:		
Basic and diluted	$ (0.59)	$ (2.77)
Weighted average common shares outstanding:		
Basic and diluted	2,844	2,775

The accompanying notes are an integral part of these consolidated statements.

PECO II, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(In thousands)

	Common Stock	Warrants	Additional Paid-In Capital	Accumulated Deficit	Total Shareholders Equity
Balance, January 1, 2008	$ $3,475	$ 5,078	$ 116,412	$ $(98,693)	$ 26,272
Stock purchase plan and restricted stock activity	98	—	(96)	—	2
Issuances from acquisition (Delta)	—	51	—	—	51
Share-based compensation	—	—	456	—	456
Expired warrants	—	(5,129)	5,129	—	—
Net loss	—	—	—	(7,704)	(7,704)
Balance, December 31, 2008	$ $3,573	$ —	$ 121,901	$ (106,397)	$ 19,077
Stock purchase plan and restricted stock activity	44	—	(41)	(1)	2
Share-based compensation	—	—	225	—	225
Net loss	—	—	—	(1,687)	(1,687)
Balance, December 31, 2009	$ $3,617	$ —	$ 122,085	$ (108,085)	$ 17,617

The accompanying notes are an integral part of these consolidated statements.

PECO II, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Years Ended December 31,	
	2009	2008
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (1,687)	$ (7,704)
Adjustments to reconcile net loss to net cash provided by (used for) operating activities:		
Depreciation and amortization	1,466	1,494
Provision for bad debts	14	316
Provision for obsolete and excess inventories	1,035	2,146
Provision for product warranty	774	1,021
Goodwill impairment	-	1,503
Gain on disposals of property and equipment	(1)	(5)
Asset impairments	-	200
Compensation expense from share-based payments	225	456
Working capital changes:		
Accounts receivable	(1,434)	(737)
Inventories	2,028	754
Prepaid expenses and other current assets	(431)	(31)
Accounts payable and other current liabilities	746	(2,396)
Net cash provided by (used for) operating activities	2,735	(2,983)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(189)	(71)
Transfer from (to) restricted cash	834	(834)
Issuance of note receivable	-	(260)
Proceeds from sale of property and equipment	26	187
Net cash provided by (used for) investing activities	671	(978)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net (repayments) usage under line of credit agreement	(834)	834
Net (decrease) increase in bank overdraft	(994)	994
Proceeds from issuance of common shares- ESPP	2	12
Net cash (used for) provided by financing activities	(1,826)	1,840
Net increase (decrease) in cash	1,580	(2,121)
Cash and cash equivalents at beginning of period	5,814	7,9355
Cash and cash equivalents at end of period	$ 7,394	$ 5,814
Supplemental Disclosure of Cash Flow Information:		
Income taxes paid, net of refunds	$ 43	$ 72
Interest paid	18	15

The accompanying notes are an integral part of these consolidated statements.

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PECO II, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except for share and per share data)

1. Summary of Significant Accounting Policies

Nature of Business

The Company provides engineering and installation on-site services and designs; manufactures and markets communications power systems and equipment; and offers systems integration products and related services for the communications industry. The Company markets its products and services primarily throughout North America.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of PECO II, Inc. (the "Company"), and its wholly owned subsidiary. The Company's investment in a joint venture is included in the consolidated financial statements using the equity method of accounting. The Company does not have any off-balance sheet arrangements or affiliated entities that require consolidation in the Company's consolidated financial statements. All significant intercompany transactions have been eliminated in consolidation.

Financial Statement Presentation and Use of Estimates

The accompanying consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States of America. Certain amounts in the prior year financial statements have been reclassified to conform to the current year presentation.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect reported amounts and disclosures. Significant estimates are used for, but not limited to, the accounting for doubtful accounts, inventory obsolescence, depreciation and amortizations, goodwill and other asset impairments, warranty costs, valuation allowance on tax assets, share-based compensation, taxes and contingencies. Actual results could differ from those estimates.

Reclassifications

In 2009, the Company's presentation of certain expenses within its consolidated statements of operations was changed. Depreciation and amortization expenses were previously recorded in the captions "Cost of sales," "Research, development and engineering" and "Selling, general and administrative." In the current year, depreciation and amortization expenses are now being presented separately under the caption "Depreciation and amortization." The Company believes that this change in presentation provides a more meaningful measure of its cost of sales and other operating expenses. These reclassifications had no effect on reported consolidated income (loss) from operations, net income (loss) or per share amounts. Amounts presented for the prior periods have been reclassified to conform to the current presentation. The following table provides the amounts reclassified for the years ended December 31, 2009 and December 31, 2008.

Amounts reclassified:	For the Years Ended December 31,	
	2009	2008

Cost of sales	$ (1,019)	$ (1,018)
Research, development and engineering	(45)	(47)
Selling, general and administrative	(402)	(429)
Depreciation and amortization	1,466	1,494
Total costs and expenses	$ -	$ -

Subsequent Events

The Company has evaluated for disclosure all subsequent events through the date the financial statements were issued and filed with the United States Securities and Exchange Commission.

Impacts of Reverse Stock Split

The Company executed a reverse stock split of the Company's common stock at a ratio of 1-for-10 shares on May 7, 2008. As a result, all periods presented in the accompanying consolidated financial statements and these notes to the consolidated financial statements have been retroactively restated. All share related data including shares outstanding, shares issuable under warrants and stock-based compensation plans and loss per share amounts reflect the reverse stock split.

Cash and Cash Equivalents

Cash equivalents consist of money market funds that are readily convertible into cash. At December 31, 2009 and 2008, the Company had money market funds totaling $5,754 and $6,647 (of which $834 is presented as restricted cash), respectively. The remaining cash and cash equivalent balances is from cash deposits maintained with banks.

Restricted Cash

We have a $3,500 demand line of credit agreement with National City Bank that requires a deposit account as collateral dependent upon the outstanding balance due on the line of credit. As of December 31, 2009, there is no outstanding balance on the line and no amounts are required to be reflected as restricted cash. As of December 31, 2008, there was an outstanding balance on the line of $834. As such, an equal amount of the Company's collateral account has been reflected as restricted cash in the accompanying consolidated balance sheet.

Accounts and Notes Receivable

Trade receivables are uncollateralized customer obligations due under normal trade terms requiring payment generally within 30 days from the invoice date. The Company grants credit on open accounts to its customers, substantially all of whom are in the telecommunication industry. Due to the nature of its customer base, the Company's historical credit risk has been low. The Company generally requires payment within thirty days from delivery and has not provided extended payment terms under any type of vendor financing arrangements. However, the Company does establish allowances against accounts receivable for potentially uncollectible amounts. The Company estimates necessary allowances based on its analysis of customers' outstanding receivables at the individual invoice level, the customers' payment history and any other known factors concerning their current financial condition and ability to pay. After the Company has exhausted its collection efforts and determined that amounts are uncollectible at the individual invoice level, such amounts are charged off against the allowance. Accounts receivable are presented net of the allowance for doubtful accounts of $100 and $120 at December 31, 2009 and 2008, respectively.

Notes receivable are stated at the principal amount with interest accrued where applicable. An allowance for uncollectible notes receivable is recorded based on our determination of probable losses based upon the specific facts and circumstances of each note receivable. At December 31, 2009 and 2008, the Company had a note receivable for $260 but has recognized a full valuation allowance as it was determined that it is probable that it won't be collected.

Bad debt expense was $14 and $316 for 2009 and 2008, respectively.

Inventories

Inventories are stated at the lower of cost or market with cost determined on a standard basis that approximates the first-in, first-out method. Inventory costs consist of purchased product, internal and external manufacturing costs, and freight. Management regularly reviews inventory for obsolescence or excessive quantities and records an allowance

accordingly. Various factors are considered in making this determination, including recent usage history, forecasted usage and market conditions.

From time to time, the Company has increased risk for obsolete and excess inventory depending on various unforeseen future events and circumstances, primarily related to the mix of future business and customer requirements for new technologies that could have a material impact on the Company's estimated allowance for obsolete and excess inventory in the near term. If these unforeseen events and circumstances do occur in the near term, the resulting change in the estimate could be material to the Company's consolidated financial position and results of operations.

In both 2009 and 2008, due to changing market conditions in the telecommunications industry and changes in demand for certain product lines, management conducted a thorough review of inventory on hand. As a result, a provision for obsolete and excess inventories of $1,035 and $2,146 was charged against operations to write down inventory to its net realizable value for 2009 and 2008, respectively. This was based on management's best estimate of current forecasted usage, customer demand patterns and plans to transition product lines to meet market demands. This provision is reflected as obsolete inventory write-off reported as a separate component of costs of goods sold in the accompanying consolidated statement of operations.

Property and Equipment

Property and equipment are stated at cost. Expenditures for improvements that extend the useful life of property and equipment are capitalized. Expenditures for maintenance and repairs are charged to expense as incurred.

Depreciation for the years ended December 31, 2009 and 2008 was $393 and $421 respectively. Depreciation is calculated using the straight-line method over the estimated useful lives of the assets. The estimated useful lives used for computing depreciation for financial statement purposes are:

	Years
Land improvements	15
Buildings and building improvements	20 to 40
Machinery and equipment	5 to 10
Furniture and fixtures	4 to 7

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable by comparing the carrying amount of an asset to fair value. If such assets are considered to be impaired, the impairment recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets classified as held for sale are reported at the lower of the carrying amount or fair value less costs to sell.

The carrying value of permanently idle assets that are not a part of the Company's long-term operating assets are segregated and presented in the other assets section of the accompanying balance sheet. Such assets are not depreciated but are evaluated for impairment to determine if the carrying value is recoverable.

Intangible Assets

Intangible assets, which consist of customer relationships and a supply agreement, have determinable lives and are amortized on a straight-line basis over the estimated useful life.

Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that included the enactment date.

The Company reviews the potential future tax benefits of all deferred tax assets on an ongoing basis. The Company's review includes consideration of historical and projected future operating results, reversals of existing deferred tax liabilities, tax planning strategies and the eligible carryback and/or carryforward period of each deferred tax asset to determine whether a valuation allowance is appropriate.

Management evaluates tax positions taken or expected to be taken on income tax returns to assess, based on each position's technical merits, if it is more likely than not that the position will be sustained upon examination by the relevant taxing authority. If it is determined that a tax position does not meet this criteria, the Company records the related tax benefit at risk as a liability or reduction of any recorded net operating loss carryforward. The Company recognizes interest and penalties associated with uncertain tax positions as components of income tax expense.

Warranties

The Company records a liability for an estimate of costs that it expects to incur under its basic limited warranty when revenue is recognized. Factors affecting the Company's warranty liability include the number of units sold and historical and anticipated rates of claims and costs per claim. The provision for warranty claims is adjusted for specific problems that may arise. At a minimum, the Company reviews the adequacy of its warranty liability quarterly based on changes in these factors.

The changes in the Company's accrued product warranty costs are as follows:

	December 31,	
	2009	2008
Accrued warranty costs, beginning of year	$ 1,012	$ 908
Annual accrual	774	1,021
Warranty claims	(646)	(917)
Accrued warranty costs, end of year	$ 1,140	$ 1,012

During 2009, actual warranty claims decreased when compared to 2008 activity. Major issues in 2008 related to legacy supplier component workmanship and design issues that resulted in a need for field replacements. These issues were all non customer service impacting, however, the Company incurred significant costs to travel to customer locations to perform the required field upgrades. A number of customers had lightning related issues that impacted our products' performance and in the interest of customer satisfaction the Company worked with the customers to resolve these issues. Most of the 2008 issues were resolved, resulting in decreased warranty claims in 2009.

Earnings per Share

Basic earnings (loss) per share is calculated by dividing net income (loss) by the weighted-average number of shares outstanding during the period. Diluted earnings (loss) per share is calculated by dividing net income (loss) by the weighted-average number of shares outstanding and common equivalent shares from stock options and unvested shares using the treasury method, except when anti-dilutive.

Revenue Recognition

Product revenues are recognized when customer orders are completed and shipped, title passes to the customer and collection is reasonably assured. Product sales sometimes include multiple items including services such as installation. In such instances, product revenue is not recognized until installation is complete and the product is made available for customer use. Services revenues on E&I contracts and the costs for services performed are primarily recorded as the work progresses on a percentage of completion basis. Management believes that all relevant criteria and conditions are considered when recognizing sales.

Cost of Goods Sold

The product segment cost of goods sold includes various components. In addition to the standard material and labor costs, there are other various expenses such as: freight, purchasing and material control costs, shipping and receiving costs, quality control costs, industrial engineering, and warehousing.

The services segment cost of goods sold include all expense items related to specific jobs, such as labor, material and freight. In addition, there are purchasing, material control, quality control and warehousing expenses.

Research, Development and Engineering Costs

Expenses associated with the development of new products and changes to existing products are charged to expense as incurred.

Selling, General and Administrative

Expenses associated with the selling, general, and administrative costs would includes executive administrative expenses, corporate governance and public reporting, accounting and finance, information technology and sales and marketing expenses.

Shipping and Handling

Shipping and handling fees billed to customers are recorded as revenue, and shipping and handling costs paid to vendors are recorded as cost of sales.

Sales Taxes

Taxes collected from customers and remitted to governmental authorities are recorded on a net basis and are therefore excluded from revenues.

Advertising Expense

The Company expenses costs of advertising as incurred.

Interest income, net

The Company records interest income and interest expense net in the accompanying consolidated statements of operations. Interest income, net was $26 and $171 for 2009 and 2008, respectively. Of this amount, interest expense during 2009 and 2008 was $18 and $14, respectively.

Financial Instruments

The Company's financial instruments consist primarily of cash and cash equivalents, receivables, payables and debt. Fair values of cash and cash equivalents, receivables and payables approximate carrying values due to their relatively short-term nature. The carrying amount of debt approximates fair value due to either the length of maturity or existence of interest rates that approximate prevailing market rates.

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash deposits, money market funds and trade accounts receivable. Cash deposits and money market funds are held at high-credit quality financial institutions that are generally insured by the Federal Deposit Insurance Corporation (FDIC) up to $250 (as temporarily increased by Congress through December 31, 2013). However, the Company does have certain money market funds held at institutions that are not FDIC insured and amounts that exceed FDIC insured amounts. At December 31, 2009, the Company had approximately $6,894 of money market funds and cash in excess of current FDIC insured limits.

Trade accounts receivable due from three customers at December 31, 2009 and 2008 was $4,724 and $2,662 respectively, which accounted for 81.6% and 60.9% of total accounts receivable due at these dates. These trade accounts receivables are reputable customers and management feels there is minor risk associated with these accounts. The Company's credit risk with respect to trade receivables is, limited in management's opinion, due to industry and geographic diversification. As disclosed, the Company maintains an allowance for doubtful accounts to cover estimated credit losses.

Recently Adopted Accounting Pronouncements

Effective for the quarterly period ended September 30, 2009, the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) became the single source of authoritative generally accepted accounting principles (GAAP) in the United States. The ASC does not change current GAAP, but introduces a new structure, organized by accounting topics, designed to simplify user access to all authoritative literature related to a particular accounting topic. All prior authoritative documents were superseded and all other accounting literature not included in the ASC is considered nonauthoritative. As a result, prior GAAP references are no longer applicable. In an effort to make the financial statements more useful, the Company has elected to omit specific GAAP references and to ensure accounting concepts and policies are clearly explained. Any new recently issued accounting pronouncements will be referenced to the FASB's Accounting Standards Update (ASU) referencing structure.

Fair value
As permitted, management elected to defer adoption of new fair value accounting standards until 2009 for nonfinancial assets and liabilities measured at fair value on a nonrecurring basis. Accordingly, beginning January 1, 2009, management began applying the new standards to nonfinancial assets and liabilities for any nonrecurring fair value measurements required. During 2009, there have been no fair value measurements on a nonrecurring basis of the Company's nonfinancial assets and liabilities that require further consideration or disclosure.

Effective for the quarterly period ended June 30, 2009, we also adopted new accounting standards that require disclosures about the fair value of financial instruments for interim reporting periods in addition to annual financial statements. The adoption of this standard does not have a material effect on our consolidated results of operations, financial position, or cash flows.

Business combinations and noncontrolling interests
Effective January 1, 2009, we adopted new accounting standards for accounting and reporting of business combinations and noncontrolling interests. We have not entered into any business combination transactions during

2009. Therefore, the effect of implementing these standards will be dependent upon the nature and extent of future business combination transactions.

Earnings per share

Effective January 1, 2009, we adopted a new accounting standard for determining whether instruments granted in share-based payment transactions are participating securities. Under the new standard, unvested share-based awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and are included in the computation of earnings per share pursuant to the two-class method. Before adoption, the Company already treated unvested share-based awards granted in share-based payment transactions as participating securities. As such, the adoption of this new standard did not have any effect on the computation of earnings per share.

Subsequent events

Effective for the quarterly period ended June 30, 2009, we adopted a new accounting standard for subsequent events. The new standard provides guidance for the accounting and disclosure of events that occur after the balance sheet date but before financial statements are issued or available to be issued. It also requires us to disclose the date through which subsequent events were evaluated and whether that date represents the date the financial statements were issued or were available to be issued. The adoption of this standard did not have a material effect on our consolidated results of operations, financial position, or cash flows.

Recently Issued Accounting Pronouncements

In October 2009, the FASB issued ASU 2009-13, Revenue Recognition (Topic 605) – Multiple-Deliverable Revenue Arrangements. This ASU provides amendments to the criteria for separating deliverables and measuring and allocating arrangement consideration to one or more units of accounting. The amendments establish a selling price hierarchy for determining the selling price of a deliverable. The ASU permits the use of the "best estimate of selling price" in addition to vendor-specific objective evidence (VSOE) and third-party evidence (TPE) for determining the selling price of a deliverable. In cases in which VSOE or TPE cannot be determined, use of the best estimate of selling price is required. In addition, the residual method of allocating arrangement consideration is no longer permitted. This new update is effective for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption is permitted. We are currently evaluating the impact that the adoption of this ASU will have on our consolidated financial statements.

2. Segment Information

The Company has identified two reportable segments: product and services. These two segments reflect the organization used by our management for internal reporting and decision making. The product segment consists of manufacturing operations and the production of power plants, rectifiers and power distribution equipment. The services segment consists primarily of telecommunications contract, engineering, and installation services. The accounting policies of the segments are the same as those described in Note 1. Earnings of the segments exclude interest income and expense and income tax (expense) benefit from the consolidated statements of operations. The Company has no significant assets located outside of the United States.

The following table summarizes certain information regarding segments of the Company's operations for the years ended December 31, 2009 and 2008:

	December 31,	
	2009	2008
	(in thousands)	
Net Sales:		
Product	$24,105	$31,554
Services	18,182	10,189
	$42,287	$41,743
Loss from operations:		
Product (1)	$(3,755)	$(5,908)
Services (2)	2,056	(1,922)
	$(1,699)	$(7,830)
Identifiable assets:		
Product	$18,794	$22,903
Services	6,576	4,236
	$25,370	$27,139
Depreciation and amortization expense:		
Product	$1,444	$1,480
Services	22	14
	$1,466	$1,494
Capital expenditures:		
Product	$85	$58
Services	104	13
	$189	$71

(1) Product segment loss from operations for the year ending December 31, 2009 includes $1,035 of obsolete inventory write-offs. Product segment loss from operations for the year ending December 31, 2008 includes $200 real estate impairment and $2,146 of obsolete inventory write-offs

(2) Services segment loss from operations for the year ending December 31, 2008 includes a goodwill impairment charge of $1,503.

3. Inventories

Inventories are summarized as follows:

	December 31,	
	2009	2008
Raw materials	$ 8,402	$ 9,924
Work-in-process	132	303
Finished goods	507	1,106
Gross inventories	9,041	11,333
Allowance for obsolete and excess inventory	(3,571)	(2,800)
Inventories, net	$ 5,470	$ 8,533

4. Uncompleted Contracts

The Company reports costs and revenues from manufacturing and installation contracts on the percentage-of-completion method of accounting determined on a basis approximating the ratio of costs incurred to total estimated costs. Contract costs are recorded in cost of revenues in the period in which they are incurred, except in the case of manufactured material, which is included in inventory until completion of the job site. When estimates indicate that a loss will be incurred on a contract, the total estimated loss is recognized currently. Changes in job performance, job conditions, estimated profitability, and final contract settlements may result in revisions to costs and income and are recognized in the year in which the revisions are determined.

The asset, “Costs and estimated earnings in excess of billings on uncompleted contracts,” represents income recognized in advance of amounts billed. The liability, “Billings in excess of costs and estimated earnings on uncompleted contracts,” represents billings in advance of revenues recognized.

Costs and estimated earnings on uncompleted contracts consist of the following:

	December 31, 2009	December 31, 2008
Costs incurred on uncompleted contracts	$ 4,586	$ 2,500
Estimated earnings	1,283	500
	5,869	3,000
Less: Billings to date	5,846	2,613
	$ 23	$ 387

Included in the accompanying balance sheet under the following captions:

	December 31, 2009	December 31, 2008
Costs and estimated earnings in excess of billings on uncompleted contracts	$ 1,158	$ 622
Billings in excess of costs and estimated earnings on uncompleted contracts	(1,135)	(235)
	$ 23	$ 387

5. Asset Impairment Charges and Assets Held For Sale

The Company has an idle facility that has not yet been sold and does not meet the criteria to be presented as held for sale. As such, the adjusted carrying value of the idle facility has been segregated from property and equipment as it is not a part of long-term operating assets and is reflected in the other assets section of the accompanying consolidated balance sheet. In 2009 and 2008, management performed the required impairment analysis on the idle facility to determine if its carrying value was recoverable. For both years, management identified recent sales data for similar facilities for sale in the area and analyzed the expected cash flows from different sales scenarios. For 2008, management recorded an impairment loss of $200 to adjust the idle facility to its estimated recoverable amount. For 2009, the impairment analysis determined that the current carrying value was recoverable.

6. Goodwill and Other Intangibles

During 2008, it was determined that due to the continued weakness in carrier spending for wireless segment, services segment goodwill recognized as part of previous acquisitions was fully impaired and an impairment charge was reflected in the statement of operations.
Intangible assets are summarized as follows and relate to the product reporting segment only:

Intangible Assets with Determinable Lives	December 31, 2009	December 31, 2008
Customer Relationships	$ 2,000	$ 2,000
Supply Agreement	3,700	3,700
Total Gross Intangible Assets	5,700	5,700
Less: Accumulated Amortization	4,025	2,952
Intangibles, net	$ 1,675	$ 2,748

Amortization expense for the years ending December 31, 2009 and December 31, 2008 was $1,073 and $1,074, respectively. Amortization is calculated using the straight-line method over the estimated useful lives of the assets. The estimated useful lives of the customer relationship and supply agreement intangibles are 6 years and 5 years, respectively.

The estimated amortization expense for future years is:

	2010	2011	2012
Customer Relationships	$ 333	$ 333	$ 84
Supply Agreement	$ 740	$ 85	$ 0
Total amortization expense	$ 1,073	$ 518	$ 84

7. Line of Credit

We have a line of credit agreement with National City Bank for borrowings up to $3,500 due on demand with interest payable monthly at LIBOR plus 1.5%. The line of credit requires certain amounts be restricted in an identified collateral account based on the outstanding balance due. The portion of the collateral account currently restricted is reflected as restricted cash in the accompanying consolidated balance sheet. As of December 31, 2009, the outstanding balance due under the line of credit was $0. As of December 31, 2008, the outstanding balance due under the line of credit was $834. The weighted average effective interest rate was 1.73% and 4.17% at December 31, 2009 and 2008, respectively.

8. Other Accrued Expenses

Other accrued expenses at December 31, 2009 and 2008 consist of the following:

	December 31,	
	2009	2008
Accrued warranty costs	1,140	1,012
Taxes, other than income taxes	196	164
Other	403	457
Total	$ 1,739	$ 1,633

9. Income Taxes

The components of the income tax expense for the years ended December 31 are as follows:

	2009	2008
Current tax expense:		
Federal	$ (5)	$ —
State and local	19	45
Total current income tax expense	14	45
Deferred tax expense:	—	—
Total income tax expense	$ 14	$ 45

A reconciliation of income tax expense by applying the statutory federal income tax rate for the years ended December 31 follows:

	2009	2008
Loss before income taxes	$ (1,673)	$ (7,659)
Computed tax benefit at the statutory federal rate	(569)	(2,604)
State and local income taxes, net of federal benefit	12	29
Change in valuation allowance	416	1,887
Non-deductible goodwill impairment	—	344
Non-deductible share-based compensation activity	79	86
Changes in effective state rates	17	411
Prior year adjustments	(1)	(113)
Other	60	5
Income tax expense	$ 14	$ 45
Effective income tax rate	(0.8)%	(0.6)%

A detailed summary of the deferred tax assets and liabilities at December 31 resulting from differences in the book and tax basis of assets and liabilities follows:

	2009	2008
Current deferred tax assets:		
Accrued compensation	$ 121	$ 208
Other accrued expenses	29	31
Inventories	1,377	996
Accrued warranty costs	457	360
Accounts receivable	128	135
Other	—	6
Total current assets	2,112	1,736
Less: valuation allowance	(2,112)	(1,736)
Net current assets	—	—
Long-term deferred tax assets:		
Net operating loss and credit carryforwards	24,028	23,977
Share-based compensation	106	189
Property and equipment	913	842
Goodwill and intangibles	2,819	2,799
Other	64	63
Total long-term assets	27,930	27,890
Less: valuation allowance	(27,930)	(27,890)
Net deferred tax asset	$ —	$ —

At December 31, 2009, the Company has unused federal net operating loss carryforwards of $66,242 generally expiring from 2022 through 2029. The Company has federal tax credit carryforwards of approximately $822 generally expiring from 2011 through 2022. The Company also has other unused state and local net operating loss carryforwards.

Based on the available objective evidence, including the Company's recent history of operating losses, management believes it is more likely than not that the net deferred tax assets will not be fully realizable. Accordingly, the Company provided for a full valuation allowance against its net deferred tax assets at December 31, 2009 and 2008.

10. Lease Commitments

The Company also has certain non-cancelable operating leases covering certain office facilities and equipment that expire at various dates through 2014. The future minimum operating lease payments for years ending December 31 are as follows:

	Operating Leases
2010	324
2011	191
2012	92
2013	93
2014	47
Total future minimum lease payments	$ 747

Aggregate rental expense on all cancelable and non-cancelable operating leases for the years ended in 2009 and 2008 approximated $276 and $322, respectively.

11. Contingencies

The Company is periodically a party, both as plaintiff and defendant, to lawsuits and claims arising out of the normal course of business. If necessary, the Company records reserves for losses that are deemed to be probable and that are subject to reasonable estimates. As of December 31, 2009 and 2008, the Company does not have any recorded legal contingencies.

The Company, each of the members of the Company's board of directors, Lineage Power Holdings, Inc. ("Lineage"), and Lineage Power Ohio Merger Sub, Inc. ("Merger Sub") were named defendants in a purported class action and shareholder derivative lawsuit filed in the Court of Common Pleas of Cuyahoga, County, Ohio, on or about March 5, 2010, and styled as follows: Harshad Sandesara v. PECO II, Inc., et al., Case No. CV 10 720332. Plaintiff is a shareholder of the Company and seeks both to enjoin the merger and damages. On March 15, 2010, plaintiff filed an amended complaint and a motion for expedited proceedings. Thereafter, on March 19, 2010, plaintiff filed a motion for preliminary injunction asking that the court block the merger. The lawsuit alleges, among other things, that the directors of the Company, aided and abetted by the Company and Lineage, breached their fiduciary duties in connection with the directors' recommendation that the shareholders adopt a proposed merger transaction between the Company and Merger Sub that would result in the Company being a wholly owned subsidiary of Lineage. On March 25, 2010, the defendants filed a motion to dismiss the amended complaint and a brief in opposition to the motion for expedited proceedings. On March 26, 2010, the Court denied plaintiff's motion to expedite discovery and ordered the Company to supplement its proxy statement filed March 18, 2010 with specific information concerning the background of the merger. At this stage, it is not possible to predict the outcome of this proceeding or its impact on the Company. The Company believes the allegations made in the amended complaint are without merit and intends to vigorously defend against the plaintiff's claims.

12. Employee Benefit Plans

The Company has a 401(k)/Profit Sharing Plan. Under the Plan, eligible employees, as defined, may elect to contribute 1% up to 100% of their annual compensation subject to certain limitations. In addition, the Company may make contributions to the Plan at the discretion of the Compensation Committee of the Board of Directors. No contributions were made by the Company in 2009 and 2008.

13. Warrants

During 2006, the Company issued a warrant as part of the purchase price consideration for an acquisition. The Warrant gave the seller the right to purchase additional shares to obtain up to 45% of the Company's issued and outstanding shares of capital stock measured as of five business days before the exercise of the Warrant, at an exercise price of $2.00 per share, exercisable immediately upon issuance and for a period of 30 months thereafter. The Warrant expired unexercised in September 2008.

14. Loss Per Share

The number of shares outstanding for calculation of loss per share is as follows:

(In thousands)	2009	2008
Weighted-average shares outstanding - basic	2,844	2,775
Effect of potentially dilutive shares	—	—
Weighted average in outstanding shares - diluted	2,844	2,775

Due to the Company's net loss for the years ended December 31, 2009 and 2008, no potentially dilutive shares were included in the calculation of diluted loss per share because their effect would have been anti-dilutive.

15. Stock-Based Compensation

The Company has one plan under which stock-based awards may currently be granted to officers and employees, including non-employee directors. The Amended 2000 Performance Plan ("2000 Plan") provides for the granting of 500,000 common shares (on a post-split basis). The Compensation Committee of the Board of Directors administers the 2000 Plan. The 2000 Plan permits the grant of stock options, restricted stock awards, and other stock and performance-based incentives.

Stock options are generally granted with an exercise price equal to the market price of the Company's common stock at the date of grant, generally vest over three to four years, and generally have a term of 5 years. Restricted stock awards generally vest in a one year period. Stock options and restricted stock awards may vest based on service requirements or specific performance criteria as determined by the Compensation Committee.

In addition to the 2000 Plan, the Company has the 2000 Employee Stock Purchase Plan ("ESPP") which reserved an aggregate of 100,000 common shares (on a post-split basis). The ESPP allows eligible employees to purchase common shares through payroll deductions, at prices equal to 85% of fair market value on the first or last business day of the offering period, whichever is lower. The Plan will terminate when all or substantially all of the common shares reserved for purposes of the plan have been purchased. The fair value of the discount is estimated at the beginning of each semi-annual payment period and vests at the end of that period.

All shares issued under both the 2000 Plan and ESPP are from newly issued common shares. The 2000 Plan and ESPP will terminate in 2010, or when all of the common shares reserved for purposes of the plan have been issued.

Total stock-based compensation expense recognized by type of award is as follows:

	2009	2008
Stock options	$ 39	$ 201
Restricted stock awards	184	252
Employee stock purchase plan	2	3
Total stock-based compensation expense	225	456
Tax effect on stock-based compensation expense	—	—
Net effect on loss from operations	$ 225	$ 456

There was no recorded tax effect on the recognition of stock-based compensation expense due to the Company's significant net operating loss carryforward and valuation reserve. In addition, there was no effect on the presentation

of the statement of cash flows as excess tax benefits from the exercise of stock options have not been recorded as the Company does not expect to be able to realize current period deductions of taxable income.

Stock Options

There were no stock option grants during 2009. The weighted-average fair value of stock options granted in 2008 was estimated $3.27 per share, respectively, using the Black-Scholes option-pricing model based on the following assumptions:

	2008	
Expected dividend	0	%
Expected volatility	60.0	%
Risk-free interest rate	3.50	%
Expected term (in years)	2.98	

Expected Term: The Company's expected term represents the period that the Company's share-based awards are expected to be outstanding and was determined based on historical experience of similar awards, given consideration to contractual terms of the awards and vesting schedules.

Expected Volatility: The fair value of share-based awards was determined using the Black-Scholes Model with a volatility factor based on regular measurements of the Company's historical stock prices.

Expected Dividend: The Company has not historically paid dividends, nor does it expect to pay dividends in the near future. Therefore, there is no expected dividend yield.

Risk-Free Interest Rate: The Company bases the risk-free interest rate used in the Black-Scholes Model on the implied yield currently available on U.S. Treasury zero-coupon issues with a remaining term equivalent to the expected term of the share-based awards.

Estimated Pre-Vesting Forfeitures: The Company considers historical pre-vesting forfeiture rates in determining the estimated number of shares that will ultimately vest.

The following table represents stock option activity for the year-to-date period ended December 31, 2009:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contract Life
Outstanding options at January 1, 2009	192,402	$ 9.98	
Granted	—	—	
Exercised	—	—	
Forfeited/Cancelled	(96,402)	$ 10.35	
Outstanding options at December 31, 2009	96,000	$ 9.62	1.68 years
Options vested or expected to vest at December 31, 2009	93,807	$ 9.66	1.65 years
Exercisable at December 31, 2009	71,100	$ 10.27	1.22 years

At December 31, 2009 there was no aggregate intrinsic value of stock options outstanding and exercisable as the exercise prices of the options were all greater than that of the average market price at the end of the period.

Restricted Stock Awards

The Company has granted restricted stock awards to certain of its employees that vest based on the attainment of certain performance goals and service requirements. Fair-values of the restricted stock awards are based on the closing market price of the Company's common stock on the grant date. At December 31, 2009, there was $61 of unrecognized compensation expense from non-vested awards that is expected to be recognized over a weighted-average remaining service period of 1.5 years. The total fair-value of restricted stock awards that vested during 2009 and 2008 was $203 and $237, respectively.

The following table represents restricted stock awards activity for the year-to-date period ended December 31, 2009:

	Number of	Weighted Average

	Shares	Grant Date Fair Value
Non-vested at January 1, 2009	45,000	$ 3.92
Granted	33,732	2.82
Vested	(60,568)	3.35
Non-vested at December 31, 2009	18,164	$ 3.79

16. Related Party Transactions

The Company engages in certain related party transactions throughout the course of its business with Delta, a significant shareholder and vendor. The Company's related party transactions with Delta, for the year ended December 31, 2009 include $128 in sales and $5,494 in purchases. At December 31, 2009, the Company had balances of $31 and $28 included in accounts receivable and accounts payable, respectively. The Company's related party transactions with Delta, for the year ended December 31, 2008 include $144 in sales and $9,041 in purchases. At December 31, 2008, the Company had balances of $11 and $485 included in accounts receivable and accounts payable, respectively.

17. Significant Customers

Sales to the top three customers amounted to $16,728, $13,505, and $1,622 and comprised approximately 40%, 32%, and 4% respectively, of consolidated net sales for 2009. Sales to our top customer included $13,940 in product and $2,788 in services, our second highest customer included $1,038 in product and $12,467 in services, and our third highest customer included $1,568 in product and $54 in services.

Sales to the top three customers amounted to $17,801, $5,170, and $4,054 and comprised approximately 43%, 12%, and 10%, respectively, of consolidated net sales for 2008. Sales to our top customer included $14,685 in product and $3,116 in services, our second highest customer included $1,381 in product and $3,788 in services, and our third highest customer included $3,986 in product and $68 in services.

18. Subsequent Events

Pending Acquisition

On February 18, 2010, we entered into an Agreement and Plan of Merger pursuant to which Lineage Power Holdings, Inc., a Delaware corporation ("Lineage"), will acquire all of our outstanding shares of common stock for $5.86 per share in cash without interest and less any applicable tax withholding. Lineage is a provider of power conversion solutions and is a portfolio company of The Gores Group, LLC, a private equity firm focused on acquiring controlling interests in mature and growing businesses. We expect the transaction to close during the second quarter of 2010, subject to approval by our shareholders.

ITEM 9—CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURES

None.

ITEM 9A(T)— CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As of December 31, 2009, the end of the period covered by this report, an evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer/Chief Financial Officer of our disclosure controls and procedures (as such term is defined in Rule 13a-15(e) or 15d-15(f) under the Securities Exchange Act of 1934). Based upon such evaluation, our Chief Executive Officer/Chief Financial Officer concluded such disclosure controls and procedures were effective as of the end of the period covered by this report.

Management's Annual Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting for the Company as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. Our internal control over financial reporting is designed to provide reasonable assurance regarding the (i) effectiveness and efficiency of operations, (ii) reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles, and (iii) compliance with applicable laws and regulations. Our internal controls framework is based on the criteria set forth in the Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

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

Management's assessment of the effectiveness of the Company's internal control over financial reporting is as of the year ended December 31, 2009. We believe that internal control over financial reporting is effective. We have not identified any, current material weaknesses considering the nature and extent of our current operations and any risks or errors in financial reporting under current operations.

This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to temporary rules of the SEC that permit the Company to provide only management's report in this annual report.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal controls over financial reporting during our fourth quarter that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

ITEM 9B— OTHER INFORMATION

None.

PART III

ITEM 10—DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The authorized number of our directors presently is fixed at nine. As required by our Amended and Restated Articles of Incorporation, the Board of Directors is divided into three classes of directors. There are currently three directors in each of Class I and Class III, and two directors in Class II. There is one vacancy in Class II. Each listed director's respective experience and qualifications described below led to the conclusion that each director is qualified to serve as a member of our board of directors.

Class I Directors

E. Richard Hottenroth, age 73 — Director since 1997.

E. Richard Hottenroth has been a member of the firm Hottenroth, Garverick, Tilson & Garverick, Co., L.P.A. since 1961. Hottenroth, Garverick, Tilson & Garverick, Co., L.P.A. provides legal services to PECO II.

Gerard B. Moersdorf, Jr., age 58 — Director since 2006.

Gerard B. Moersdorf, Jr. is the founder and innovator behind a start-up company called ACScout that has been highly successful from its inception in late 2006. He was also the founder of Applied Innovation Inc., which was acquired by Kentrox, Inc. in May 2007. Mr. Moersdorf served as Applied Innovation's Chairman of the Board from 1986 to May 2007, President, Chief Executive Officer, and Treasurer from 1986 to 2000 and as its President and Chief Executive Officer from August 2002 to January 2005.

R. Louis Schneeberger, age 55 — Director since 2003.

Since January 2010, R. Louis Schneeberger has been a Director of Qorval LLC, an international business advisory firm providing financial restructuring, operational turnaround, due diligence and management services to private equity groups, lenders/creditors and stakeholders of underperforming or troubled enterprises. In 2008 and 2009, Mr. Schneeberger was a Partner and Managing Director of Knowledge Investment Partners, an alternative investment firm focused on the education sector. In November of 2009, Mr. Schneeberger became a Director of Energy Focus, Inc. (NASDAQ: EFOI) a public company that designs, develops, manufactures, and markets lighting systems for use in both the general commercial market and the pool market. From November 2005 to December 2007, Mr. Schneeberger was an independent consultant who focused on assisting in several mergers and acquisitions and performing the chief financial officer function for a Cleveland based large private company. From February 2004 to November 2005, Mr. Schneeberger served as Chief Financial Officer for OM Group, Inc, a $1.3 billion international producer of metal-based specialty chemicals. Mr. Schneeberger is an experienced public-company executive with a background in public accounting and as a strategist, turnaround specialist, and business advisor. He was chief financial officer and a director of Olympic Steel, Inc. (NASDAQ: ZEUS) from 1987 to 2000 and Chairman of the

Board and audit committee of Royal Appliance Manufacturing Company (NYSE: RAM) from July 1995 to April 2003. He began his career with Arthur Andersen (1977 to 1987).

Class II Directors

John G. Heindel, age 55 — Director since 2005.

John G. Heindel became Chairman of the Board of Directors of our Company in June 2006, President and Chief Executive Officer of the Company in July 2005, and Chief Financial Officer and Treasurer in January 2008. Prior to his service with the Company, Mr. Heindel provided strategic consulting services since June 2003 to various companies interested in making acquisitions in the communications industry. Prior to his work as a consultant, Mr. Heindel spent more than 22 years with Lucent Technologies and its predecessor companies, most recently as the company's President, Worldwide Services.

Thomas R. Thomsen, age 74 — Director since 2003.

Thomas R. Thomsen is a veteran of more than 45 years in the telecommunications industry. His career includes 32 years with Western Electric/AT&T, where he held responsibilities for manufacturing, services, marketing, sales and administration at the senior executive level. After retiring from AT&T in 1990 he served as Chairman of the Board and CEO of Lithium Technology Corp., a publicly held development stage company, from August 1995 to November 1999. Mr. Thomsen currently serves on the board of EF Johnson Technologies, Inc., a company with a class of securities registered pursuant to the Securities Exchange Act of 1934, where he has been a director since July 1995, and the Executive Committee for the University of Nebraska Technology Park. Previously, he served on the boards of Western Electric, Sandia Corp, Olivetti Inc., AT&T Credit Corp., Lithium Technology Corp., and Rensselaer Polytechnic Institute.

Class III Directors

James L. Green, age 82 — Director since 1988.

James L. Green was one of the founders of PECO II in 1988, served as Chairman of the Board of Directors until July 2001, served as Chief Executive Officer from 1988 to 1990 and April 2003 to June 2006, and as the President from 1989 to 1990 and April 2003 to June 2006. Mr. Green has over 50 years of experience in the communications industry. From 1983 to 1988, Mr. Green also worked as a management consultant in the international communications industry. From 1983 to 1985, Mr. Green was President and Chief Executive Officer of NovAtel Communications, Ltd. in Calgary, Canada. From 1953 to 1983, Mr. Green served in various capacities with the Power Equipment Company, North Electric Company and ITT, the predecessor businesses of PECO II, Inc.

Richard W. Orchard, age 56 — Director since 2006.

Mr. Orchard is a retired telecommunications executive with over 25 years experience in sales, operations and general management. Mr. Orchard most recently served as Chief Transition Officer of Sprint Nextel Corporation in connection with the merger of Sprint and Nextel Communications, Inc. from December 2004 until late 2005. Prior to his role as Chief Transition Officer, Mr. Orchard served as Nextel's Senior Vice President and Chief Service Officer and prior to that as Eastern Regional President. Prior to joining Nextel, Mr. Orchard also served in various capacities for AirTouch and PacTel for ten years and Motorola Communications for five years. Mr. Orchard is also a director of Grande Communications Holdings, Inc., a company subject to the reporting requirements of Section 15(d) of the Securities Exchange Act of 1934.

Matthew P. Smith, age 56 — Director since 1994.

Matthew P. Smith is self-employed as a private investor in technology and energy companies. Mr. Smith is a managing member of Paquin Energy and Fuel President of Firenze Valley Farms Inc. and serves on the Board of two other technology related forms. Mr. Smith served as the Chairman of the Board from July 2001 until July 2005. Mr. Smith was employed by PECO II in various capacities between 1989 and May 2004, including as Chief Executive Officer from 1998 to June 2002, and as our President from 1998 to July 2001. From 1996 to 1998, he served as Executive Vice President, from 1991 to 1998, he served as Secretary, and from 1990 to 1998 he served as Treasurer.

Executive Officers

The executive officers of the Company are elected annually by the Board of Directors and serve at the pleasure of the Board. In addition to John G. Heindel, President, Chief Executive Officer, Chief Financial Officer and Treasurer, the following person is an executive officer of the Company.

Eugene A. Peden, age 44 — Senior Vice President/Operations and Corporate Secretary since June 2009.

Mr. Peden previously had held the position of Vice President of Operations since joining PECO II in January 2008. Mr. Peden spent his career in corporate operations positions in Ireland, Thailand, the United Kingdom and the United States. Prior to joining the Company, Mr. Peden worked for Rittal Corporation, one of the largest enclosure manufacturers in the world. In his most recent position as Senior Vice President, Operations, Mr. Peden led a re-engineering of Rittal's operations, driving significant culture change by establishing a customer-focused organizational structure, instituting cost-control measures and implementing lean manufacturing practices.

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Securities Exchange Act of 1934 requires our executive officers and directors and persons who own 10% or more of a registered class of our equity securities, to file reports of ownership and changes in ownership on Forms 3, 4 and 5 with the SEC. Executive officers, directors and 10% or greater shareholders are required by SEC regulations to furnish us with copies of all Forms 3, 4 and 5 they file.

Based solely on our review of the copies of such forms we have received, we believe that all of our executive officers and directors complied with all filing requirements applicable to them.

Code of Ethics

The Board has adopted a Code of Conduct and Ethics that applies to all of PECO II's employees, officers and directors. These documents can be found on our website at www.peco2.com by clicking on the link for Investor Relations. If we make any substantive amendments to our code or grant any waivers, including any implicit waivers, from a provision of our code to any director or executive officer, we will disclose the nature of such amendment on our website and any waiver in a Current Report on Form 8-K.

Audit Committee

The Board of Directors maintains an Audit Committee, whose members include R. Louis Schneeberger (Chairman), Gerard B. Moersdorf, Jr., and Richard W. Orchard. The Audit Committee hires, oversees and reviews the activities of our independent registered public accounting firm and various company policies and practices. The specific functions and responsibilities of the Audit Committee are set forth in the Audit Committee Charter adopted by the Board of Directors. Our Board has determined that each of the members of the Audit Committee satisfies the current independence standards of the Nasdaq Stock Market listing standards and Section 10A(m)(3) of the Securities Exchange Act of 1934, as amended. The Audit Committee met four times in 2009.

The Board also has determined that R. Louis Schneeberger is an "audit committee financial expert" as that term is defined in Item 407(d)(5)(ii) of Regulation S-K. As an "audit committee financial expert," Mr. Schneeberger satisfies the Nasdaq financial literacy and sophistication requirements.

ITEM 11—EXECUTIVE COMPENSATION

Summary Compensation Table

The following table shows the compensation paid by PECO II, Inc. to each of the Named Executive Officers (NEOs) of the Company for the 2009 and 2008 fiscal years.

SUMMARY COMPENSATION TABLE

Name and Principal Position	Year	Salary ($)	Bonus ($)	Stock Awards ($)(1)	Option Awards ($)(1)	Non-Equity Incentive Plan Compensation ($)	All Other Compensation ($)(2)	Total ($)
John G. Heindel Chairman of the Board, President, Chief Executive Officer, Chief Financial Officer and Treasurer	2009	217,669		74,999	–	139,283	11,322	443,273
	2008	160,000	–	137,478	64,192	–	10,242	371,912
Jacquie L. Boyer(3) Former Vice President of Sales	2009	71,639	25,000	–	–	35,772	66,915	199,326
	2008	125,008	_	_	48,150	40,043	240	213,441

and Sales Operation								
Eugene A. Peden Senior Vice President of Operations & Packaged Power	2009	158,355	25,000	10,001	–	74,191	240	267,787
	2008	146,548	25,000	10,000	68,480	–	240	250,268

(1) Represents the aggregate grant date fair value computed in accordance with FASB ASC Topic 718. Assumptions made in the valuation of the awards are disclosed in Note 15 of the Notes to the Consolidated Financial Statements in this Form 10-K.

(2) Amounts include the following:

- $240 of group term insurance premiums paid on behalf of Mr. Peden and $120 of group term insurance premiums paid on behalf of Ms. Boyer in 2009; and $240 and $168 of group term insurance premiums paid on behalf of Mr. Peden and Ms. Boyer in 2008;

- $2,322 of executive life insurance premiums paid on behalf of Mr. Heindel in 2009 and $1,242 of executive life insurance premiums paid on behalf of Mr. Heindel in 2008;

    - a $750 monthly car allowance paid on behalf of Mr. Heindel in 2009 and 2008;

- Ms. Boyer received a severance payment of $66,795 per her individual separation agreement.

(3) Ms. Boyer resigned as the Company's Vice President of Sales and Sales Operations, effective as of June 30, 2009.

Non-Equity-Based Compensation

We have an annual non-equity incentive compensation plan, which in 2009 was called the 2009 Incentive Compensation Plan (the "2009 IC Plan"). The goal of the 2009 IC Plan is to tie incentive compensation directly to the growth and profitability of our Company. The 2009 IC Plan pays cash awards to our employees based upon the achievement of both key company-wide performance goals and personal performance goals unique to the individual IC Plan participant.

For NEOs, 80% of the potential payout was tied to the achievement of company-wide performance goals, which were the achievement of revenue and EBITDA (earnings before interest, taxes, depreciation and amortization) targets. The revenue and EBITDA threshold targets must both be met before there are any payouts under the 2009 IC Plan, and each of these targets accounted for 50% of the company-wide performance goal portion of the 2009 IC Plan. The remaining 20% of the potential payout under the 2009 IC Plan was tied to the achievement of individual performance goals for each NEO.

Upon the achievement of the threshold revenue and EBITDA targets, our NEOs had the opportunity to receive threshold, target and maximum incentive compensation as follows:

Incentive Compensation Payout Opportunities for 2009

	Threshold	Target	Maximum
John G. Heindel	$ 75,000	$ 150,000	$ 300,000
Jacquie Boyer	$–– 42,500	$ 85,00	$ 170,000
Eugene A. Peden	$ 29,000	$ 58,000	$ 117,000

In 2009, the EBITDA target was met and, as a result, the following payouts were made under the 2009 IC Plan. Mr. Heindel received $139,283 and Mr. Peden received $74,191. In 2009, Ms. Boyer earned $35,772 from commissions. Ms. Boyer and Mr. Peden also each earned a $25,000 bonus in 2009.

Equity-Based Compensation

We believe that emphasis on equity-based compensation opportunities encourages a high level of long-term performance that enhances shareholder value, thereby further linking leadership and shareholder objectives. Equity compensation also serves to attract and retain the best available individuals to serve as our NEOs. Equity compensation is intended to motivate our NEOs to contribute to our future growth and profitability and to reward their performance in a manner that:

- provides them with a means to increase their holdings of the common stock of our Company;
- encourages our NEOs to be long-term shareholders; and
- aligns their interests with the interests of the shareholders of the Company.

Equity compensation is granted to our NEOs under our Amended 2000 Performance Plan (the “Plan”), which was approved (as amended) by our shareholders on April 24, 2004. The Compensation/Nominating Committee of our Board of Directors determines the award opportunity level for each NEO based on the individual’s responsibility level and potential within our Company, competitive practices, the number of shares available for grant, business needs, individual and Company performance, shareholder returns and the market price of our common stock. The Committee considers these factors subjectively in the aggregate. Because the Committee believes that each of these factors is significant, and the relevance of each factor may vary depending on the duties and responsibilities of each executive officer, the Committee does not assign a formula weight to any single factor in determining the amount of a grant. Instead, the Committee examines each factor in the context of individual and Company performance and business needs, internal pay equity where applicable, and incumbent pay history.

We have granted both stock options and restricted stock to our NEOs under the Plan. Under the Plan, stock options are granted at market price and typically vest 40% after the first year and 30% for second and third years; however, no stock options were granted in 2009. In 2009, we granted restricted stock covering 3,165 shares to Mr. Peden, of which 1,583 shares vested on December 31, 2009 and 1,582 shares are scheduled to vest on June 30, 2010.

In 2009, we also granted Mr. Heindel $40,000 of restricted stock based on fair market value on the date of grant, in lieu of any increase in his base compensation. In addition, Mr. Heindel agreed to take $35,000 of his annual salary for 2009 in the form of restricted stock during the last seven months of 2009.

All Other Compensation

The all other compensation category in our Summary Compensation Table consists of the following:

- employer-paid premiums for life insurance;
- employer-paid car allowance; and
- payments under employment/severance agreements.

We provide each of our associates, including NEOs, with the option to purchase basic group term life insurance with a death benefit equal to two times their annual salary at a discounted premium. This element of compensation, though relatively inexpensive, provides one additional item to the overall compensation package which strengthens our ability to recruit and retain talented associates.

We also provide Mr. Heindel with an individual term life insurance policy in the amount of $1,000,000, which policy shall be payable in the amount of $500,000, together with a gross-up of premiums to the designated beneficiaries of Mr. Heindel and any balance to the Company, if Mr. Heindel shall become deceased at any time during the term of this agreement or extensions or renewals thereof as defined in said policy. As part of our employment agreement with Mr. Heindel, we provide Mr. Heindel with a monthly car allowance.

In addition, we offer our employees, including our NEOs, a comprehensive benefits program. This program is designed to provide the employees and their families with competitive coverage at competitive rates. We strive to provide the employees with appropriate health benefits (medical, pharmacy, dental, and vision) to help protect the physical, mental and financial health of our employees and their immediate families.

Agreements with NEOs

In an effort to attract and retain the services of our NEOs, we have entered into an employment agreement with Mr. Heindel, our Chairman, President, Chief Executive Officer, Chief Financial Officer and Treasurer and Mr. Peden, our Senior Vice President of Operations.

Agreement with Mr. Heindel

On January 4, 2010, the Company and Mr. Heindel entered into an employment agreement (the “Employment Agreement”). The Employment Agreement has an initial term ending on December 31, 2011. At the end of the term, including any renewal extensions thereof, the Employment Agreement will automatically renew for an additional one-year period, unless either party gives 90 days’ prior written notice to the other party of its intent not to renew the Employment Agreement. Mr. Heindel is entitled to an annual base salary of $300,000, which will be reviewed and may be increased subject to the approval of the Compensation/Nominating Committee. In addition, pursuant to the

terms of the Employment Agreement, the Company has granted Mr. Heindel such number of shares of restricted stock under the Company's Amended 2000 Performance Plan equal to (i) $40,000 divided by (ii) the closing price of our common stock on the date of grant, on January 4, 2010 and is obligated to make a similar grant on January 3, 2011. The grants of restricted stock will vest on December 31, 2010 and December 31, 2011, respectively.

Under the Employment Agreement, Mr. Heindel is eligible to participate in any cash bonus plan which is established from time to time in an amount determined by the Committee, and Mr. Heindel is eligible for awards granted under the Company's Amended 2000 Performance Plan, at the discretion of the Committee. Mr. Heindel is entitled to a car allowance of $750 per month during the term of the Employment Agreement. The Company has agreed to obtain a life insurance policy for a duration of not less than the term of the Employment Agreement upon the life of Mr. Heindel in the amount of $1,000,000, which policy shall be payable $500,000 together with gross-up of premiums to the beneficiaries of Mr. Heindel and any balance to the Company.

In the event of a termination due to the death or Disability (as defined in the Employment Agreement) of Mr. Heindel, Mr. Heindel's employment will be deemed terminated as of the end of the month in which such death occurs or Disability is determined, and the Company will pay to Mr. Heindel, or his beneficiary, base salary and benefits for a period of 90 days from the deemed termination date. In addition, Mr. Heindel's stock options will immediately vest 100% upon his death or Disability and may be exercised for 90 days from the deemed termination date but no later than their expiration date.

In the event of a termination of Mr. Heindel for Cause (as defined in the Employment Agreement), all obligations of the Company to Mr. Heindel shall cease.

On February 18, 2010, the Company, and Mr. Heindel, entered into an Amendment No. 1 (the "Amendment") to the Employment Agreement. The Amendment clarified certain payments that would be due Mr. Heindel if a change of control (as defined in the Employment Agreement) occurs at any time during the term of the Employment Agreement, and within six months following the date of the change of control either (1) Mr. Heindel terminates his employment for any reason or (2) the Company terminates Mr. Heindel's employment for any reason other than for Cause (as defined in the Employment Agreement).

If a change of control (as defined in the employment agreement), such as the proposed merger, occurs at any time during the term of the employment agreement, and within six months of the date following the change in control either (i) Mr. Heindel terminates his employment for any reason or (ii) the Company terminates Mr. Heindel's employment for any reason other than for Cause, then Mr. Heindel is entitled to the following: two times the sum of (1) Mr. Heindel's annual salary in effect on the date of termination , and (2) the cash value of the annual restricted stock grant to Mr. Heindel, measured as of the grant date, and (3) the annual or incentive bonus earned by Mr. Heindel in the most recently completed fiscal year. In addition, upon any such termination, Mr. Heindel is entitled to the continued payment of his family COBRA health insurance coverage for a maximum of 18 months from the date of termination and stock options will immediately vest 100% and may be exercised for a period of 12 months from the termination date.

The Amendment also contains provisions to ensure compliance with certain Internal Revenue Code sections, and to ensure any amount of payments determined to be nondeductible to the Company under Section 280G of the Internal Revenue Code will be reduced to the maximum amount which would cause all of the payments to be deductible by the Company.

In the event of a termination without Cause upon not less than 90 days' advance written notice under the Employment Agreement, the Company will pay to Mr. Heindel: (i) base salary for an additional 12 months in accordance with normal payroll practices and (ii) an amount equal to any accrued cash bonuses (that are accrued at the time of termination) in a lump sum within three months after such termination. The Company may accelerate the effective date of the termination without Cause, if the Company increases the amount payable to Mr. Heindel to an amount equal to the amount Mr. Heindel would receive following termination within six months of a change of control, as described above. In addition, Mr. Heindel's stock options and restricted stock will immediately vest 100% upon termination and his stock options may be exercised for 90 days from the termination date but no later than their

expiration date.

In the event of a termination by Mr. Heindel without Good Reason (as defined in the Employment Agreement) upon not less than 90 days' advance written notice to the Company, the Company shall pay to Mr. Heindel base salary and benefits for a period of 90 days from the date of such notice. In addition, Mr. Heindel's stock options may be exercised for 90 days from the termination date but not later than their expiration date.

In the event of a termination by Mr. Heindel with Good Reason, the Company shall pay to Mr. Heindel an amount equal to the amount Mr. Heindel would receive following termination within six months of a change of control, as described above. In addition, Mr. Heindel's stock options and restricted stock will immediately vest 100% and his stock options may be exercised for 90 days from the termination date but not later than their expiration date.

Under the Employment Agreement, Mr. Heindel has also agreed not to compete against the Company for a period of one year following any termination of Mr. Heindel's employment with the Company. The Amendment further provides that during this one-year period and for an additional six-month period thereafter, Mr. Heindel may not be employed or engaged by, perform any services for, invest in or become associated in any capacity with certain competitors of the Company.

Agreement with Mr. Peden

On November 29, 2007, as amended January 27, 2010, the Company and Mr. Peden entered into an employment agreement, which provides for an initial base salary on $150,000, which has been increased since the date of his hiring. The employment agreement also provides that Mr. Peden is entitled to an annual cash bonus of $50,000, subject to the achievement of annual business goals. Upon entering into his employment agreement, Mr. Peden received a signing bonus of $25,000 and an option to purchase 20,000 PECO II common shares, of which 40% vested one year after his third year of employment. Upon entering his employment agreement, Mr. Peden was entitled to Company-provided local housing, the opportunity to earn 5,000 shares of restricted stock awarded to him based on the achievement of 2008 performance goals, participation in the Company benefits package after approximately one month of employment, 15 vacation days, and additional financial support for certain expenses not to exceed $14,000.

If a change of control (as defined in his employment agreement) occurs, and Mr. Peden is terminated within 12 months following the change of control, Mr. Peden is entitled to receive cash compensation equivalent to one year's base pay, and his stock options and restricted stock will immediately vest 100% and may be exercised for a period of 90 days from the termination date.

If, within six months following a change of control, Mr. Peden terminates his employment for good reason, Mr. Peden is entitled to receive cash compensation equivalent to one year's base pay, and his stock options and restricted stock will immediately vest 100% and may be exercised for a period of 90 days from the termination date. Good reason is generally defined in Mr. Peden's employment agreement to mean the occurrence of (1) any material change with respect to the diminution or reassignment of title, appointment, authority, or reporting relationship of Mr. Peden; (2) the assignment or relocation of Mr. Peden to a location outside of a 50 mile radius from PECO II's headquarters or Mr. Peden's residence; or (3) the failure of PECO II to pay Mr. Peden's salary or any amounts otherwise vested or due under any plan or policy of PECO II.

Outstanding Equity Awards at Fiscal Year-End Table

The following table provides information concerning unexercised options, stock that has not vested, and equity incentive plan awards outstanding as of the end of the last completed fiscal year:

OUTSTANDING EQUITY AWARDS AT FISCAL 2009 YEAR-END

	Option Awards					Stock Awards			
Name	Number of Securities Underlying Unexercised Options (#) Exercisable	Number of Securities Underlying Unexercised Options (#) Unexercisable	Equity Incentive Plan Awards: Number of Securities Underlying Unexercised Unearned Options (#)	Option Exercise Price ($)	Option Expiration Date	Number of Shares or Units of Stock That Have Not Vested (#)	Market Value of Shares or Units of Stock That Have Not Vested ($)	Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not	Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights

								Vested (#)	That Have Not Vested ($)
John G.Heindel	50,000	–	–	10.70	07/28/2010	–	–	–	–
	8,000	12,000 (1)	–	7.50	01/03/2013	–	–	–	–
Jacquie L. Boyer(3)	–	–	–	–	–	–	–	–	–
Eugene A. Peden	8,000	12,000 (2)	–	8.00	01/01/2013	–	–	–	–
	–	–	–	–	–	1,582 (4)	7,704	–	–

(1) 6,000 shares vested on January 3, 2010 and 6,000 shares vest on January 3, 2011.

(2) 6,000 shares vested on January 1, 2010 and 6,000 shares vest on January 1, 2011.

(3) Ms Boyer resigned effective June 30, 2009. Per her separation agreement, Ms Boyer had until December 31, 2009 to exercise any vested options.

(4) Shares are scheduled to vest on June 30, 2010.

Compensation of Directors

In July 2009, each non-employee director was granted an annual cash retainer of $10,000, payable on a quarterly basis, for service from July 1, 2009 to June 30, 2010. In addition to the annual cash retainer, each non-employee member of the Company's Board of Directors receives the following fees per meeting attended:

Meeting Type	Fee Per Meeting
Board Meeting	$ 1,000
Committee Meeting	$ 1,000
Committee Meeting, Chairperson	$ 1,500

Each board member is also entitled to reimbursement for all reasonable out-of-pocket expenses incurred in connection with his or her attendance at a board or committee meeting.

Employees and officers who are directors receive no additional compensation for services as directors. The Board of Directors, upon the recommendation of the Compensation/Nominating Committee, sets the compensation for non-employee directors. The table below shows the compensation earned by the Company's non-employee directors during 2009:

DIRECTOR COMPENSATION FOR 2009

Name	Fees earned or paid in cash ($)	Total ($)
James L. Green	16,000	16,000
E. Richard Hottenroth	24,250	24,250
Gerard B. Moersdorf, Jr.	19,900	19,900
Richard W. Orchard	24,700	24,700
R. Louis Schneeberger	29,000	29,000
Matthew P. Smith	16,000	16,000
Thomas R. Thomsen	22,800	22,800

ITEM 12—SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Equity Compensation Plan Information

The following table sets forth information concerning common shares authorized or available for issuance under our equity compensation plans as of December 31, 2009:

Plan Category	Number of Securities to be Issued Upon Exercise of	Weighted-Average Exercise Price of Outstanding Options,	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans

	Outstanding Options, Warrants and Rights (a)	Warrants and Rights (b)	(Excluding Securities Reflected in Column (a)) (c)
Equity compensation plans approved by shareholders(1)	114,164	$ 9.62	202,803
Equity compensation plans not approved by shareholders	–	–	–
Total	114,164	$ 9.62	202,803

(1) Equity compensation plans approved by shareholders include the Amended 2000 Performance Plan and the 2000 Employee Stock Purchase Plan.

Security Ownership of Certain Beneficial Owners and Management

The number of shares beneficially owned by each shareholder is determined under rules issued by the Securities and Exchange Commission. This information is not necessarily indicative of beneficial ownership for any other purpose. Under these rules, beneficial ownership includes any shares as to which the individual or entity has sole or shared voting power or investment power as of the measurement date and any shares as to which the individual or entity has the right to acquire beneficial ownership within 60 days after such measurement date, through the exercise of any stock option or other right. Unless otherwise indicated, each person or entity named below has sole voting power and investment power with respect to the number of shares set forth opposite his, her or its respective name.

Ownership of Common Shares by Certain Beneficial Owners

The following table shows information regarding beneficial ownership of our common shares as of March 12, 2010, unless otherwise indicated, by each person, entity or group which is known by us to own beneficially more than 5% of our common shares.

Name and Address of Beneficial Owner(1)	Common Shares Beneficially Owned	Percent Owned	
Delta International Holding Ltd.(2)	474,037	16.6	%
Water Island Capital, LLC(3)	350,874	12.3	%
Austin W. Marxe and David M. Greenhouse(4)	336,082	11.8	%
Skiritai Capital LLC(5)	306,670	10.7	%
Matthew P. Smith(6)	282,495	9.9	%
Linda H. Smith(7)	282,495	9.9	%
James L. Green(8)	199,431	7.0	%
Mary Janet Green(9)	199,431	7.0	%
ROI Capital Management, Inc.(10)	199,362	7.0	%
John G. Heindel(11)	148,683	5.1	%

(1) The address of Delta International Holding Ltd. is Scotia Center, 4th Floor, P.O. Box 2804, George Town, Grand Cayman, Cayman Islands. The address for Water Island Capital, LLC is 41 Madison Ave., Suite 2802, New York, NY 10010. The address for Austin W. Marxe and David M. Greenhouse is 527 Madison Ave., Suite 2600, New York, NY 10022. The address of Skiritai Capital LLC is 388 Market Street, Suite 700, San Francisco, CA 94111. The addresses for Mr. Heindel, Mr. and Mrs. Smith and Mr. and Mrs. Green are c/o PECO II, Inc., 1376 State Route 598, Galion, OH 44833. The address of ROI Capital Management, Inc. is 300 Drakes Landing Road, Suite 175, GreenBrae, CA 94904.

(2) Based on information provided in a Schedule 13D filed on April 7, 2006 by Delta International Holding Ltd., Delta Electronics, Inc. and Delta Products Corporation.

(3) Based on information provided in a Schedule 13G filed March 10, 2010 by Water Island Capital, LLC.

(4) Based on information provided in a Schedule 13G/A filed on February 12, 2010, by Austin W. Marxe and David M Greenhouse, controlling principals of AWM Investment Company, Inc. ("AWM"), the general partner of and investment adviser to Special Situations Cayman Fund, L.P. AWM also serves as the general partner of MGP Advisers Limited Partnership, the general partner of and investment adviser to Special Situations Fund III, L.P., and the general partner of and investment advisor to Special Situations Fund QP, L.P. Marxe and Greenhouse share voting and investment power over 104,452 common shares owned by Special Situations Cayman Fund, L.P., 231,630 common shares owned by Special Situations Fund III QP, L.P. and zero common shares owned by Special Situations Fund III, L.P.

(5) Based on information provided in a Schedule 13G filed on April 23, 2008 by Skiritai Capital LLC ("Skiritai"), Leonidas Opportunity Fund L.P. ("Leonidas Fund"), Leonidas Opportunity Offshore Fund Ltd. ("Leonidas Offshore Fund"), Russell R. Silvestri ("Silvestri"), and Lyron L. Bentovim ("Bentovim"). Skiritai serves as the general partner of the Leonidas Fund and investment manager of the Leonidas Offshore Fund. Silvestri and Bentovim are Managing Directors of Skiritai.

(6) Mr. Smith is a director of PECO II. Mr. Smith's ownership includes 132,495 shares held by Mr. Smith and his spouse, Linda H. Smith, as joint tenants, 100,000 common shares held by Ashwood I, LLC and 50,000 common shares held by Ashwood II, LLC. Mr. Smith has shared voting and dispositive power over the securities held by these limited liability companies.

(7) Ms. Smith's ownership includes 132,495 common shares held by Ms. Smith and her spouse, Matthew P. Smith, as joint tenants, 100,000 common shares held by Ashwood I, LLC, and 50,000 common shares held by Ashwood II, LLC. Ms. Smith has shared voting and dispositive power over the securities held by these limited liability companies.

(8) Mr. Green is a director of PECO II. Mr. Green's ownership includes 189,070 common shares held by The Green Family Trust and 10,361 held by The Green Charitable Trust, both over which he shares voting and dispositive power with his spouse, Mary Janet Green.

(9) Ms. Green's ownership includes 189,070 common shares held by the Green Family Trust and 10,361 held by the Green Charitable Trust, both over which she shares voting and dispositive power with her spouse, James L. Green.

(10) Based on information provided in a Schedule 13G/A filed February 16, 2010 by ROI Capital Management, Inc., Mark T. Boyer, and Mitchell J. Soboleski. Messrs. Boyer and Soboleski beneficially own these securities pursuant to their ownership interest in ROI Capital Management, Inc., which beneficially owns these securities as an investment advisor for certain persons who have the right to receive, or the power to direct the receipt of, dividends from, or proceeds from the sale of, these securities.

(11) Mr. Heindel is our Chairman of the Board, President, Chief Executive Officer, Chief Financial Officer and Treasurer. Mr. Heindel's ownership includes 64,000 common shares issuable within 60 days after March 12, 2010 upon the exercise of stock options.

Ownership of Common Shares by Management

The following table shows information regarding beneficial ownership of our common shares as of March 12, 2010, by each director, each of our named executive officers, and all of our directors and executive officers as a group.

Name and Address of Beneficial Owner(1)	Common Shares Beneficially Owned	Percent Owned	
Jacquie L. Boyer(2)	0	*	
James L. Green(3)	199,431	7.0	%
John G. Heindel(4)	148,683	5.1	%
E. Richard Hottenroth(5)	12,275	*	
Gerard B. Moersdorf, Jr.(6)	2,000	*	
Richard W. Orchard(7)	1,500	*	
Eugene A. Peden(8)	20,583	*	
R. Louis Schneeberger(9)	1,750	*	
Matthew P. Smith(10)	282,495	9.9	%
Thomas R. Thomsen(11)	2,000	*	
All directors and executive officers as a group (9 persons)(12)	670,717	22.8	%

* Less than 1%.

(1) The address of the directors and executive officers listed is c/o PECO II, Inc., 1376 State Route 598, Galion, Ohio 44833.

(2) Ms. Boyer resigned as the Company's Vice President of Sales and Sales Operations, effective as of June 30, 2009. The table reflects no shares directly held by Ms. Boyer as of June 30, 2009.

(3) Mr. Green is a director of PECO II. Mr. Green's ownership includes 189,070 common shares held by The Green Family Trust and 10,361 shares held by The Green Charitable Trust over which he shares voting and dispositive power.

(4) Mr. Heindel is our Chairman of the Board, President, Chief Executive Officer, Chief Financial Officer and Treasurer. Mr. Heindel's ownership includes 64,000 common shares issuable within 60 days after March 12, 2010 upon the exercise of stock options.

(5) Mr. Hottenroth is a director of PECO II. Mr. Hottenroth's ownership does not include 6,500 common shares held by his spouse.

(6) Mr. Moersdorf, Jr. is a director of PECO II.

(7) Mr. Orchard is a director of PECO II.

(8) Mr. Peden is our Senior Vice President of Operations. Mr. Peden's ownership includes 14,000 common shares issuable within 60 days after March 12, 2010 upon the exercise of stock options.

(9) Mr. Schneeberger is a director of PECO II.

(10) Mr. Smith is a director of PECO II. Mr. Smith's ownership includes 132,495 shares held by Mr. Smith and his spouse as joint tenants, 100,000 common shares held by Ashwood I, LLC and 50,000 common shares held by Ashwood II, LLC. Mr. Smith has shared voting and dispositive power over the securities held by these limited liability companies.

(11) Mr. Thomsen is a director of PECO II.

(12) Ownership of all directors and executive officers as a group includes an aggregate of 78,000 common shares issuable within 60 days after March 12, 2010 upon the exercise of stock options.

ITEM 13—CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

Director Independence

The Board of Directors has determined that the following of its members are "independent" under the listing standards of the Nasdaq Stock Market: Messrs. Hottenroth, Orchard, Moersdorf, Jr., Schneeberger, and Thomsen.

Mr. Hottenroth is a partner in the law firm Hottenroth, Garverick, Tilson & Garverick, Co., L.P.A. Although Mr. Hottenroth's law firm provided legal services to PECO II in 2009 (and will continue to provide such services in 2010), the amount of legal fees paid to that firm in 2009 did not exceed the non-independence thresholds as set forth by the Nasdaq listing standards. The Board is aware of this relationship and determined that the payments made to Mr. Hottenroth's firm did not interfere with the exercise of his independent judgment as a director.

The independent directors intend to meet at least twice a year in executive sessions. Any independent director can request that an additional session be scheduled. The Company encourages each member of the Board of Directors to attend each annual meeting of shareholders. All of the Company's directors who were members of the Board at last year's annual meeting of shareholders held on May 19, 2009, were in attendance.

Transactions with Related Person

It is the written policy of the Company that the Audit Committee will review the material facts of all related party transactions that require approval and either approve or disapprove of the entry into the related party transaction. A related party transaction is any transaction between the Company and any related party, other than (i) transactions available to all employees generally; (ii) transactions involving less than $5,000 when aggregated with all similar transactions; (iii) compensation of executive officers or directors if required to be reported in the Company's proxy statement; or (iv) transactions where the related party's interest arises solely from the ownership of the Company's common stock, and all holders of the Company's common stock receive the same benefit on a pro rata basis.

A related party includes: (i) a senior officer of director of the Company; (ii) a shareholder owning in excess of five percent of the Company (or its controlled affiliates); (iii) an immediate family member of a senior officer or director; or (iv) an entity owned or controlled by the foregoing or an entity in which one of the foregoing has a substantial ownership interest or control of such entity.

The Company is party to a Supply Agreement, dated September 29, 2008, between the Company and Delta Electronics, Inc. ("Delta") which is a successor agreement to a previous supply agreement between the Company and Delta, and allows the Company to access Delta's substantial engineering capabilities and high-quality, cost-effective component manufacturing for its power systems. Delta is a "related person" as defined in the instructions to Item 404(a) of Regulation S-K because it is an affiliate of Delta International Holding Ltd., which beneficially owns more that 5% of our common stock. For the year ended December 31, 2009, the Company's transactions with Delta under the Supply Agreement and its predecessor included $128 thousand in sales and $5.494 million in purchases.

ITEM 14— PRINCIPAL ACCOUNTING FEES AND SERVICES

Independent Registered Public Accounting Firm

Our Audit Committee engaged Battelle & Battelle LLP ("Battelle") as the Company's independent registered public accounting firm for 2009. Battelle has served as the Company's independent registered public accounting firm since 2005.

The fees billed by Battelle in 2009 and 2008 for the indicated services performed during 2009 and 2008 were as follows:

	Fiscal Year 2009	Fiscal Year 2008
Audit Fees	$ 160,800	$ 173,400
Audit-Related Fees	9,500	10,500
Tax Fees	–	–
All Other Fees	–	–
Total	$ 170,300	$ 183,900

Audit Fees for 2009 and 2008 were for professional services rendered for the audit of our annual consolidated financial statements and the review of our consolidated financial statements included in our Quarterly Reports on Form 10-Q.

Audit-Related Fees for 2009 were for time and costs incurred related to the proposed sale of the Company. For 2008, fees were for professional services rendered for accounting and SEC consultation related to the audit of our annual consolidated financial statements and the review of our consolidated financial statements included in our Quarterly Reports on Form 10-Q.

Pre-Approval of Policies and Procedures

The Audit Committee has adopted a policy that requires advance approval of all audit and non-audit services provided by our independent registered public accounting firm to the engagement of the independent registered public accounting firm with respect to such services. The Chairman of the Audit Committee has been delegated the authority by the Audit Committee to evaluate and pre-approve the engagement of the independent registered public accounting firm when the entire Audit Committee is unable to do so. The Chairman must report all such pre-approvals to the entire Audit Committee at the next committee meeting.

None of the services described above were approved by the Audit Committee under the de minimus exception to pre-approval provided in Securities and Exchange Commission rules.

PART IV

ITEM 15—EXHIBITS, FINANCIAL STATEMENT SCHEDULES

The following documents are filed as part of this report:

(a) (1) Financial Statements—See Index to Financial Statements at Item 8 of this report.

(a) (2) Financial Statement Schedules. None.

(a) (3) Exhibits.

See the “Exhibit Index” at page E-1 of this Form 10-K.

SIGNATURES

Pursuant to the requirements of Section 13 or 15 (d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PECO II, INC.

By: /s/ John G. Heindel
John G. Heindel
Chairman, President, Chief Executive Officer, Chief Financial Officer, and Treasurer

March 31, 2010

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ JOHN G. HEINDEL John G. Heindel	Chairman, President, Chief Executive Officer, Chief Financial Officer, and Treasurer (Principal Executive Officer and Principal Financial Officer)	March 31, 2010
/s/ SCOTT A WALLACE Scott A. Wallace	Corporate Controller (Principal Accounting Officer)	March 31, 2010
/s/ James L. Green James L. Green	Director	March 31, 2010
/s/ E. RICHARD HOTTENROTH Richard Hottenroth	Director	March 31, 2010
/s/ Gerard B. Moersdorf, JR. Gerard B. Moersdorf, Jr.	Director	March 31, 2010
/s/ Richard W. Orchard Richard W. Orchard	Director	March 31, 2010
/s/ MATTHEW P. SMITH Matthew P. Smith	Director	March 31, 2010
/s/ R. Louis Schneeberger R. Louis Schneeberger	Director	March 31, 2010

/s/ Thomas R. Thomsen Thomas R. Thomsen	Director	March 31, 2010

EXHIBIT INDEX

Exhibit No.	Description
2.1	Asset Purchase Agreement, dated October 13, 2005, between PECO II, Inc. and Delta Products Corporation (E)
2.2	Agreement and Plan of Merger, dated February 18, 2010, by and among the Company, Lineage Power Holdings, Inc., and Lineage Power Ohio Merger Sub, Inc. (T)
3.1 (i)	Amended and Restated Articles of Incorporation of the Company (I)
3.1 (ii)	Second Amended and Restated Code of Regulations of the Company (J)
3.1 (iii)	Amendment No. 1 to Amended and Restated Articles of Incorporation of the Company (N)
4.1	Specimen certificate for the common shares, without par value, of the Company (A)
**10.1	Security Agreement, dated September 23, 2009, between PECO II, Inc. and National City Bank
**10.2	Promissory Note, dated September 23, 2009, between PECO II, Inc. and National City Bank as lender
*10.3	2000 Performance Plan of the Company (A)
*10.4	Amendment 1 to 2000 Performance Plan of the Company (C)
*10.5	Form of Stock Option Agreement for 2000 Performance Plan of the Company (A)
*10.6	Form of Restricted Stock Award Agreement for 2000 Performance Plan of the Company (D)
*10.7	Form of Indemnification Agreement (A)
*10.8	Employment Agreement, dated January 4, 2010, between PECO II, Inc. and John G. Heindel (S)
10.9	Support Agreement and Irrevocable Proxy, dated October 13, 2005, between the Company, Delta Products Corporation and certain Significant Holders of the Company (F)
10.10	Supply Agreement, dated May 18, 2009, between the Company and DEI (P)
10.11	Schedule of Director Fees (H)
10.12	

	Description of the Material Terms of PECO II, Inc.'s Non-equity Incentive Compensation Plan for Fiscal 2009 (P)
10.13	Release and Waiver Agreement Between the Company and Jacquie L. Boyer (R)
10.14	Voting Agreement, dated February 18, 2010, by and among the Green Family Trust U/A/O 03/16/1995, the Green Charitable Trust U/A/O 05/09/2001, Matthew P. Smith, Linda H. Smith, Ashwood I, LLC, Ashwood II, LLC, the Company, Merger Sub, and Parent (T)
21.1	Subsidiaries of the Company (G)
**23.1	Consent of Battelle and Battelle LLP
**31.1	Rule 13a-14(a) Certification of Chief Executive Officer and Chief Financial Officer as adopted pursuant to Section 302 of Sarbanes-Oxley Act
**32.1	Section 1350 Certification of Chief Executive Officer and Chief Financial Officer as adopted pursuant to Section 906 of Sarbanes-Oxley Act

* Management contract or compensation plan or arrangement identified pursuant to Item 14 (c) of this Form 10-K.

** Furnished with this Annual Report on Form 10-K.

(A) Incorporated by reference to the appropriate exhibit to the Company's Registration Statement on Form S-1 (File No. 333-37566) and the amendments thereto.

(B) Reserved.

(C) Incorporated by reference to the Company's Definitive Proxy Statement for the Annual Shareholders Meeting on April 29, 2004 and filed on March 31, 2004.

(D) Incorporated by reference to the appropriate exhibit to the Company's Current Report on Form 8-K dated July 28, 2005 and filed on August 1, 2005.

(E) Incorporated by reference to the appropriate exhibit to the Company's Current Report on Form 8-K dated October 13, 2005 and filed on October 13, 2005.

(F) Incorporated by reference to the appropriate exhibit to the Company's Current Report on Form 8-K/A dated October 13, 2005 and filed on January 20, 2006.

(G) Incorporated by reference to the appropriate exhibit to the Company's Annual Report on Form 10-K for the year ended December 31, 2005 and filed on March 24, 2006.

(H) Incorporated by reference to the appropriate exhibit to the Company's Current Report on Form 8-K dated June 1, 2006 and filed on June 7, 2006.

(I) Incorporated by reference to the appropriate exhibit to the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2006 and filed on August 14, 2006.

(J) Incorporated by reference to the appropriate exhibit to the Company's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2006 and filed on May 15, 2006.

(K) Incorporated by reference to the appropriate exhibit to the Company's Current Report on Form 8-K dated January 29, 2008 and filed on February 1, 2008.

(L) Reserved.

(M) Reserved.

(N) Incorporated by reference to the appropriate exhibit to the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2008 and filed on August 14, 2008.

(O) Reserved.

(P) Incorporated by reference to the appropriate exhibit to the Company's Current Report on Form 8-K, dated May 18, 2009, and filed on May 22, 2009.

(Q) Reserved.

(R) Incorporated by reference to the appropriate exhibit to the Company's Current Report on Form 8-K, dated June 30, 2009, and filed on July 7, 2009.

(S) Incorporated by reference to the appropriate exhibit to the Company's Current Report on Form 8-K, dated January 4, 2010, and filed on January 8, 2010.

(T) Incorporated by reference to the appropriate exhibit to the Company's Current Report on Form 8-K, dated February 18, 2010, and filed on February 19, 2010.