PECO II INC
Form 10-K
March 24, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2005

Commission File No. 000-31283

PECO II, INC.

(Exact name of registrant as specified in its charter)

Ohio	**34-1605456**
(State or other jurisdiction of	**(I.R.S. Employer**
Incorporation or organization)	**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:

None

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

Common Shares, without par value

(Title of Class)

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

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 x

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 twelve 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 x No ¨

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. x

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Exchange Act Rule 12b-2).

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer x

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

The aggregate market value of the registrant s common shares, without par value, held by non-affiliates of the registrant was approximately $12.9 million on June 30, 2005.

On March 1, 2006, the registrant had outstanding 21,954,741 of its common shares, without par value.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2006 Annual Meeting of Shareholders are incorporated by reference in Part III hereof.

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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 5,750,000 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, service capabilities. In June 2001, we acquired Thornton Communications and in August 2001, we acquired JNB Communications. On October 13, 2005, we entered into a definitive asset purchase agreement (the Asset Purchase Agreement) with Delta Products Corporation (Delta) to acquire the assets that related to Delta s Telecom Power Division, consisting of exclusive rights to business supply agreements with wireline and wireless communications providers and related inventory and to assume the liabilities associated therewith of Delta s U.S. and Canadian service provider business. In exchange, we will issue 4,740,375 of our common shares without par value (the Primary Shares) to Delta and a warrant to purchase up to approximately 13.2 million of our common shares, or such other number of shares that, when aggregated with the Primary Shares, will represent 45% of our 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 transactions contemplated by the Asset Purchase Agreement are expected to close by March 31, 2006. We entered into the Asset Purchase Agreement because we believe that the transactions contemplated thereby will provide us with access to Delta s manufacturing capabilities and supply agreements, which are expected to reduce our cost of goods sold. Also, we will gain access to new customers and new markets with existing customers and improve our future product development capabilities. We will obtain standardized components for manufacturing and the union will also enable us to streamline manufacturing toward standardized products, which is also expected to lower our cost of goods sold.

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, manufacturing 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 market place (wireline & wireless), with the majority of our current revenue being generated in North America. The North American market consists of multiple segments that include Regional Bell Operating Companies (RBOCs), Independent Telephone Companies, Inter-exchange Carriers/Competitive Access Providers, Wireless, Cable TV, Private Network/Enterprise, and Government.

Wireline companies, including the RBOCs and Independent Telephone Companies, continue to upgrade their respective networks to meet the evolving needs of the local service area. Traditionally, they provided basic

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dial tone within a major metropolitan area. Over the past several years they have expanded their product set to include high-speed data access solutions such as DSL. Most are currently implementing, or have an initiative to offer, next generation high-speed data/video offerings such as FTTN (fiber to the node) and FTTP (fiber to the premises) in order to compete against the cable companies and 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 a partnership to compete against the incumbent telephone company of a given area. Recent regulatory changes have increased the competitive pressure and have created significant infrastructure write-offs and mergers and acquisitions activity in these sectors.

Wireless providers continue to build and expand at the highest rate. Mergers and acquisitions in 2004 resulted in four large North American organizations competing for the largest growth sector among individual subscribers. In 2004, wireless subscribers passed the number of wireline 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 subscribers services via high speed wireless technologies such as EVDO (Evolution Version Data Only), HSPA (High Speed Packet Access), and UMTS (Universal Mobile Telecommunications System).

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 build are underway to offer VOIP (Voice Over Internet Protocol), service and protect their market from the new video and data offerings currently planned by the incumbent telephone company in an area.

The Private Network/Enterprise market has traditionally been focused at providing in building dial tone services to commercial organizations. Though growth in these commercial organizations is not forecasted to increase in the coming years, the services required of commercial organizations is expanding due to the new product enhancements available in the last several years. Some of these enhancements include in-building wireless, video conferencing, web page commerce, as well as support infrastructure to maintain these services during any 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 timeframe of the current Homeland Security communication infrastructure build is expected to continue for the next several years.

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 offering. Our long term strategy is to:

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

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;

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internally work on methods to dramatically improve cycle time;

leverage power systems 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 where we will expand to support our strong customer demand market potential;

negotiate service partnerships with regional tier 1 service organizations in markets where we do not plan to have a presence to provide our customers with a turnkey solution offering;

focus on leveraging system integration and assembly capability by streamlining operationally to ensure the most responsive resources in the industry as we continue to reengineer our supply chain;

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 for smaller footprint, larger power, highly flexible power systems.

Business Segments

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

Products

During 2005, we introduced a midsize power system platform targeted at the wireless base station market. The new platform leveraged the building blocks of our previous products while incorporating new designs that achieved our highest power density in this product category. The new platform design led to the development of customized solutions that were accepted as standard by multiple wireless carriers. In addition to the new platform, we continued to evolve our current systems by developing derivative versions of our standard products, enabling us to grow our position in both the wireless and wireline markets. Thirty-seven development projects were completed in 2005 to enhance existing product lines as well as design the new platform.

For 2006, our focus is on designing new power systems that continue to build on our modular design concept. This design model will position us to develop high volume systems for our major customers, while also allowing us to rapidly respond to requirements for new customers or applications. The use of basic building blocks maximizes the effectiveness of our supply chain to produce improved time to market and lower costs.

We will continue to enhance our broad array of products, providing our customers a full service vendor for power solutions. Our product portfolio includes small, medium and large power systems, secondary distribution systems, monitoring and control systems, and ancillary power conversion systems such as inverters and DC-DC converters. This broad portfolio enables us to meet the needs of our customers, regardless of the power application. Our major product categories and building blocks are defined below.

Product Category	Purpose	Range of Products
Battery Plants	Converts and distributes 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, mobile radio, LAN/ WAN and broadband networks.

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Product Category	Purpose	Range of Products
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 and measurement equipment	Distributes and limits power from a centralized power plant to various loads or end uses.	We offer a wide range of products ranging 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 48V-12V, 24V-48V, 48V-24V

		and 48V-130V conversions.
Inverters	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.
Monitoring	Monitors and reports the performance of power systems.	Monitoring options can be included with power plants or as standalone products.

Services

In 2005, we refocused our efforts to build on our existing embedded base, as well as select key markets to focus our growth efforts. This restructure enable us to secure growth from our focus areas enabling growth from both our capital deployment activities, as well as after market services. We continue to emphasize vertical selling tactics in order to maximize our potential exposure of our services and product portfolio with all active customers. Our services and programs include:

- Capital Deployment Engineering & Installation Services
  - Power
  - Outside Plant
  - Transmission
- Project Management
- After Market Services
  - Cell Site/Remote Terminal Services
    - Power, Grounding, Site Expansion Audits

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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 solution reputation within the Telecommunication industry.

Marketing and Sales

We participate in the North American market place through channels such as direct sales, Value Added Resellers (VARs), and distribution. Direct sales people are located throughout the United States in order to call directly on all tier one PECO II customers, as well as provide local sales support to our tier one VARs. Our current tier one customer base includes all the RBOCs, along with the leading North American Wireless, Inter-exchange, Independent Telephone, and Cable TV carriers. In addition to the current active customer base, direct sales people are also assigned to prospective strategic customers.

VARs are utilized as both a channel to tier two and three customers, as well as to supplement the account penetration in regions where our coverage may be limited. Ninety percent of all international sales efforts are originated and executed by local VARs within the target country.

Distributors are utilized to support the local needs of our customer base as required. This channel supports small local carriers and installation groups who have established purchasing practices with the local branch.

Marketing/Business Development is located at our headquarters in Ohio, and is responsible for all pricing, promotion, and the coordination of all next generation product and service offerings. We identify product needs from the market place through feedback from our customers, our sales personnel, in house engineering staff, and service 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 the long history of being a class A supplier to the leading North American Telecommunication marketplaces. Our hybrid portfolio of customer solutions allows us to participate in capital deployment projects with 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 2005, the tier one wireless carriers provided us with over 62% of our revenue. The major portion of this revenue came from manufactured products (power systems and outside plant cabinets), however an increased demand was placed on our services portfolio (engineering, installation, maintenance contracts, site audits, and training). Companies utilizing our solution portfolio in this segment include Sprint Nextel, Verizon Wireless, and Cingular.

The RBOCs made up 12% of our 2005 revenue, with a very heavy emphasis on our services offerings. We are currently selling to all of the RBOCs (BellSouth, SBC, Verizon, and Qwest).

The Independent Telephone Company market made up 7% of our 2005 revenue, and included a healthy mix of services along with our traditional manufactured products.

The remaining revenue comes from a large number of other customers that can be classified as Competitive Access Providers, Inter-exchange Carriers, Government, Original Equipment Manufacturers, Cable TV, as well as international partners/service providers. Some of the customers who make up this group include Sprint Long Distance, MCI, Level 3, Time Warner Telephone, and IBM.

Backlog

As of December 31, 2005, the unshipped customer order backlog totaled $3.6 million, compared to $4.5 million as of December 31, 2004. We expect to ship the entire December 31, 2005 backlog in 2006.

Operations and Quality Control

The goal of our operations and technical services team is to establish a strategy to achieve world class status through 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. Likewise, through the development and deployment of quality process tools throughout PECO II, we aim to dramatically improve our processes and associate involvement in our quest to excellence. By accomplishing the above, we will position ourselves to ensure customer satisfaction, which will enhance our ability to grow our business and excite our associates.

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 for 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 customer 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).

The technical services team provides our customers with 24 hour / 365 day fast and friendly support. Services include product training, field product services, PowerPro® inventory management software, monitoring products and services, site audits, and factory product repairs. These are key support solutions to ensure that our customers have the best buying experience with PECO II.

Through continuous improvement of processes in 2005, we experienced cost improvements in products, manufacturing operations, and technical services. We also gained new markets due to cross-functional team efforts to deliver quality products on time to meet our customers expectations.

We have valuable customer relationships, product knowledge, systems integration, and services expertise. We maintain the concept 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 needs for products, systems integration, and services.

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Research, Development and Engineering

In 2005, we continued to invest in the design and development of new system solutions for the telecommunications market. Our recruiting and training of personnel and our development tools emphasize system level design and integration. This systems integration capability provides flexibility in the utilization of power conversion modules, allowing us to focus product development on customer specific opportunities. As a major supplier to the largest Telecommunications Service Providers, we have continued to invest in standards compliance, including NEBS.

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, that we will continue to develop proprietary products or technologies that are patentable, that any issued patent will provide us with any competitive advantages or will not be challenged by third parties or 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 both commodities, including steel, aluminum, copper, and electrical components as well as modules, and other sub-assemblies are vital to our success. We continue to build on our current relationships and cultivating new suppliers to ensure that we achieve reduced product costs and improved delivery, making us more cost competitive in the marketplace. Cost improvements are achieved through advanced planning with the key suppliers to ensure materials are purchased at the optimum quantities as well as improving the overall supply chain cycle time from raw materials to finished assemblies and/or sub-assemblies. This will provide us the opportunity to better respond to customer needs to provide quality products and meet the ever increasing demands for short delivery intervals.

As an example, the business relationship between PECO II and Delta Products Corporation over approximately the last four years was administered through a supply agreement. This supply agreement encouraged our R&D design group to work toward standardized product lines with emphasis on modularity. Upon the completion of the Delta Products Corporation, North American telecom division asset acquisition by PECO II, Inc., to be concluded by March 31, 2006, we will continue to strive for standardized components for manufacturing to streamline toward standardized products and, in addition, expect to lower our cost of goods sold. Another result of the new supply agreement will be input to future designs to support our market needs for state of the art products.

In 2005, raw materials such as copper, steel, aluminum, and petroleum based materials have been in a state of price volatility. Cross-functional teams cooperatively with our key suppliers are focused to evaluate methods to manage the cost impact to product designs and ensure delivery of the best value to PECO II customers.

Competition

The global market place is served by a number of local and global DC power organizations. These organizations can be broken down into full service providers, discount vendors, as well as new age vendors. In North America, we are considered one of three full service vendors, along with Emerson/Marconi and Tyco. 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 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 1 wireless providers. Participating as a full service DC power vendor generally requires a long history of top customer relationships, as well as a large embedded base.

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In addition to the full service vendors, the North American market place 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, which allows them to participate in the wireless market place 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 that 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

As of December 31, 2005, we had 352 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 RISKFACTORS

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 in 2005, as reflected in increased capital expenditures by service providers and growing demand for telecommunications services. Although we believe the overall market will continue to grow, the rate of growth could vary and is subject to substantial fluctuations. The specific market segments in which we participate may not experience the growth of other segments. In that case, 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 three key customers that each account for over 10% of our revenues. In 2005, sales to our ten largest customers accounted for approximately 85% of net sales. We expect that we will continue to be dependent upon a limited number of customers for a significant portion of our

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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 on terms favorable to us or 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 or related products or otherwise respond to unanticipated competitive pressures and our business, operating results and financial condition could be materially adversely affected.

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 in the past and will in the future vary significantly 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 our 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 one wireless providers, and the timing of such orders and their fulfillment has caused and will continue to 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 that 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.

Our pending acquisition of the assets related to Delta s Telecom Power Division may not result in additional sales from the business supply agreements that we acquired.

On October 13, 2005, we entered into a definitive asset purchase agreement with Delta Products Corporation (Delta) to acquire the assets that related to Delta s Telecom Power Division, consisting of exclusive rights to business supply agreements with wireline and wireless communications providers and related inventory

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and to assume the liabilities associated therewith of Delta s U.S. and Canadian service provider business. This acquisition is expected to close by March 31, 2006. There can be no assurance that we will actually realize our projected additional revenue from these business supply agreements, and failure to do so could materially adversely affect our business, results of operation and financial condition.

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, which 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 will lose revenue opportunities if we do not decrease the time it takes us to fill our customers orders.

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. A customer s selection of power equipment is often based on which supplier can supply the requested equipment within a specified time period.

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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. This could impair our ability to grow or even to maintain our current levels of revenues and earnings.

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 secret, copyright and trademark laws, nondisclosure and other contractual agreements and technical measures to protect our proprietary rights. Despite our efforts to protect our proprietary 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 taken by us 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 and 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 executive, operating officers, and other personnel. 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 stock 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.

Ownership of our common stock 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 28.8% of our common stock as of February 28, 2006. In particular, Messrs. Matthew P. Smith and James L. Green, and their respective affiliates, own outright approximately 23.6% of our common stock as of February 28, 2006. In addition, upon closing of the Asset Purchase Agreement, Delta Products Corporation (Delta) will own 4,740,375 shares or approximately 17.8% of our common shares and will have a warrant to purchase up to approximately 13.2 million shares of our common shares, or such other number of shares that, when aggregated with the 4,740,275 shares, will represent 45% of our issued and outstanding shares of capital stock measured as of five business days before the exercise of the warrant. As a result, these shareholders are able 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.

If we are unable to successfully address the material weakness in our internal controls, our ability to report our financial reports on a timely and accurate basis may be adversely affected.

In connection with the preparation of Annual Report on Form 10-K for year ended December 31, 2004, we identified a material weakness in our internal control over financial reporting. The identified material weakness in our internal control over financial reporting relates to insufficient controls over the identification of relevant revenue recognition issues in our contracts with our customers and resulted in adjustments being recorded in our financial statements for the year ended December 31, 2004. Our management discussed the material weakness with our former independent registered public accounting firm, KPMG LLP, and the Audit Committee of our Company s Board of Directors on March 25, 2005.

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Throughout 2005, we have continued to implement improvements in this area to attempt to eliminate this material weakness. Such remediation efforts include:

- the review of all new customer contracts by senior management;
- communication to internal parties of contract clauses affecting financial statements;
- implementation of processes affecting revenue recognition; and
- the retention in November 2005 of an external consultant to assist in review of risk assessment with relation to contracts and revenue recognition.

Although we believe that there has been significant improvement in the operation of our internal controls over financial reporting since the identification of the material weakness, we believe that the material weakness has not been fully remediated to date. The material weakness will not be considered fully remediated until the procedures resulting from the remediation effort associated with our external consultant, are fully implemented, operate for a period of time, are tested, and we conclude that such procedures are operating effectively. If we are unable to successfully address the identified material weaknesses in our internal controls, our ability to report financial results on a timely and accurate basis may be adversely affected.

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.

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ITEM 2 PROPERTIES

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

Location	Approximate Square Feet	Uses	Owned/Leased
Galion, Ohio(A)	429,000	Principal executive and corporate office, sales and service office, and manufacturing and assembly	Owned
Canton, Georgia	12,343	Engineering, installation services and sales office	Leased
Worthington, Ohio	5,248	Engineering office	Leased
Bristol, Tennessee	4,000	Engineering, installation services and sales office	Leased
Kansas City, Kansas	950	Sales office	Leased
Audubon, Pennsylvania(B)	875	Sales office	Leased
San Carlos, California	250	Sales office	Leased

(A) Includes the Galion, Ohio new corporate office shell, which is listed for sale, consists of 186,000 square feet and is recorded as a current asset on our consolidated balance sheets. Also includes the new manufacturing building consisting of 144,000 square feet that was sold in January 2006.

(B) Lease expired in February 2006.

We have continued to narrow our excess capacity for our current operations and continue to attempt to sell or sublease 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.

ITEM 4 SUBMISSION OF MATTERS TO VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders during the fourth quarter of fiscal 2005.

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PART II

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

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 of our common shares on the Nasdaq Capital Market for the periods set forth below:

2005	High	Low
First Quarter	$ 1.20	$ 1.00
Second Quarter	$ 1.29	$ 0.92
Third Quarter	$ 1.44	$ 0.96
Fourth Quarter	$ 1.85	$ 1.16
2004		
First Quarter	$ 1.52	$ 1.04
Second Quarter	$ 1.27	$ 0.84
Third Quarter	$ 0.85	$ 0.60
Fourth Quarter	$ 1.32	$ 0.60

As of February 7, 2006, there were 585 holders of record of our common shares.

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.

Recent Sales of Unregistered Securities

During the fourth quarter of 2005, no unregistered securities were sold.

Use of Proceeds

On August 17, 2000, the SEC declared effective a Registration Statement on Form S-1 (File No. 333-37566) filed by us in connection with an initial public offering of our common shares.

From the date of receipt of the proceeds through December 31, 2005, of the $78.3 million in net proceeds, $14.4 million was used to repay bank indebtedness, $5.2 million was used in connection with the acquisitions of Thornton Communications and JNB Communications, $16.7 million was used for capital expenditures, excluding the purchase of the Denver regional service center in February 2001 which was financed through industrial revenue bonds, $3.6 million has been restricted by the Company s bank to secure outstanding borrowings, $5.8 million has been used to pay off the industrial revenue bonds as a result to the sale of the Denver regional service center, $2.7 million was used to settle assumed litigation from an acquisition in 2001, and approximately $21.1 million was used for general working capital purposes. The remaining cash equivalents consist of commercial paper and state and municipal securities that are readily convertible into cash and have original maturities of three months or less.

ITEM 6 SELECTED FINANCIAL DATA

The selected data in this section should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations, the consolidated financial statements and notes to consolidated financial statements. We derived the statement of operations data for the five years ended December 31, 2005 and balance sheet data as of December 31, 2005, 2004, 2003, 2002, and 2001, from the audited financial statements.

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	Years Ended December 31,				
	2005	2004	2003	2002	2001
	(In thousands, except per share data)				
Net sales	$ 42,447	$ 31,564	$ 38,607	$ 62,060	$ 106,743
Cost of goods sold	36,575	27,461	42,039	68,154	88,365
Impairment of product segment machinery and equipment			3,300		
Inventory impairment			8,633	8,000	
Gross margin	5,872	4,103	(15,365)	(14,094)	18,378
Operating expenses:					
Research, development and engineering	3,446	2,956	3,786	9,729	11,218
Selling, general and administrative	7,659	7,958	10,350	21,269	18,836
Impairment of service segment goodwill		5,987	5,700		
Real estate impairment	1,746		1,203	2,000	
	12,851	16,901	21,039	32,998	30,054
Loss from operations	(6,979)	(12,798)	(36,404)	(47,092)	(11,676)
Loss from joint venture	(10)	(84)			
Loss from operations after joint venture	(6,989)	(12,882)	(36,404)	(47,092)	(11,676)
Interest income, net	178	149	91	308	1,300
Loss before income taxes and before cumulative effect of accounting change	(6,811)	(12,733)	(36,313)	(46,784)	(10,376)
Benefit (provision) for income taxes	(12)	463	(54)	6,916	3,695
Loss before cumulative effect of accounting change	(6,823)	(12,270)	(36,367)	(39,868)	(6,681)
Impairment of goodwill				(1,835)	
Net loss	$ (6,823)	$ (12,270)	$ (36,367)	$ (41,703)	$ (6,681)
Loss per common share before cumulative effect or accounting change:					
Basic	$ (0.32)	$ (0.57)	$ (1.72)	$ (1.85)	$ (0.31)
Diluted	$ (0.32)	$ (0.57)	$ (1.72)	$ (1.85)	$ (0.31)
Net Loss per common share:					
Basic	$ (0.32)	$ (0.57)	$ (1.72)	$ (1.94)	$ (0.31)
Diluted	$ (0.32)	$ (0.57)	$ (1.72)	$ (1.94)	$ (0.31)
Weighted average number of common shares:					
Basic	21,627	21,488	21,220	21,506	21,579
Diluted	21,627	21,488	21,220	21,506	21,579

December 31,

	2005	2004	2003	2002	2001
			(In thousands)		
Balance Sheet Data:					
Working capital	$ 23,604	$ 23,800	$ 28,148	$ 51,911	$ 81,351
Total assets	40,304	53,981	65,524	108,856	160,168
Total long-term liabilities	354	448	535	691	10,433
Total shareholders equity	30,854	37,430	49,537	85,787	128,884

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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 E&I, 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. Several of our customers have engaged in mergers, acquisitions and divestitures, such as SBC acquiring AT&T, Verizon acquiring MCI, Alltel acquiring Western Wireless, and Sprint acquiring NEXTEL. Also, both Sprint-Nextel and Alltel are in process of spinning off their local wireline businesses and focusing on their core wireless businesses. 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 and deploying 3G data services.

While the telecommunications market is extremely volatile, capital expenditure spending expanded in 2005 by 8.9% and analysts have projected further growth in 2006 and 2007. We believe this growth forecast provides us with an opportunity to capitalize on our customers capital expenditure plans.

In 2005, we targeted the capital expenditure growth in the wireless market by developing a variety of new midsize products. The 128HP product was created to serve the wireless base station market, including both cabinet and hut applications. The 128HP was well received by the market, and is already standardized at one of the large wireless operators.

We introduced complementary versions of the 128F and 129F in 2005. The two products serve 48V and +24V applications, and are used in both the wireless and wireline markets. Both products were in key customer trials at the end of 2005.

We also embarked on a plan to extend the life cycle of our venerable 162 platform of products. We are upgrading the system to modern digital rectifiers that provide our customers with additional features such as higher power conversion efficiency, front panel test jacks, enhanced EMI filtering and microprocessor control.

While we focused much of our efforts on capitalizing on the demand for midsize systems, we also continued to refine our longstanding line of Battery Distribution Fuse Bays (BDFB) as well as our large modular power plant. These developments enabled us to continue to be deployed in large switching offices in both the wireline and wireless markets.

Our breadth of products expanded when we redesigned our inverter product line, the 827E, to target the needs of operators who were utilizing AC-powered equipment in traditionally DC-powered offices. The initial response to the product has been very positive. The 827E can also be packaged with our DC products to provide the customers a turnkey solution for DC and AC power.

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The only impact we foresee an impact from as a result of recent consolidation in the telecommunication industry is the loss of Nextel 135 product line revenues from one of our major wireless customers. We anticipate that additional revenue generated from our proposed Delta acquisition will cover the loss of the specific Nextel product line, but we anticipate continuing to do business with Nextel in other areas.

Critical Accounting Policies Accounting

Our significant accounting policies are described in Note 1 to the Consolidated Financial Statements. The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. These estimates and assumptions are based on management s judgment and available information and consequently, actual results could be different from these estimates.

In response to the SEC s Release No. 33-8040, Cautionary Advice Regarding Disclosure about Critical Accounting Policies, we consider certain accounting policies related to revenue recognition, inventory valuation and impairment of long lived assets to be critical policies due to the estimation processes involved in each. We state these accounting policies on the notes to the consolidated financial statements and at relevant sections in this discussion and analysis.

Revenue Recognition

In December of 2003, the SEC issued Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition, which supercedes SAB No. 101, Revenue Recognition in Financial Statement. SAB No. 104 s primary purpose is to rescind accounting guidance contained in SAB No. 101 related to multiple element revenue arrangements, supercede as a result of the issuance of EITF 00-21, Revenue Arrangements with Multiple Deliverables. The issuance of SAB No. 104 reflects the concepts contained in EITF 00-21. The issuance of SAB No. 104 did not have a material impact on our results of operations, financial position or cash flows.

Revenue is recognized in accordance with SAB No. 104. Revenues are recognized when customer orders are completed and shipped. Sales of equipment where we also perform installation are deferred until installation is complete. Revenues on engineering and installation contracts and the costs for services performed are recorded as the work progresses on a percentage of completion basis. Accruals for the cost of product warranties are maintained for anticipated future claims.

Goodwill and Intangible Assets

An annual review of goodwill is prepared as of October 31 of each year. An independent third party performed the review of goodwill that is attributed to our service segment as of October 31, 2005, and it was determined there was no further impairment. As of 2004, the review resulted in a $6.0 million impairment and was primarily the result of the loss of a significant service customer. An independent third party performed a review as of October 31, 2003 and determined that there was no further impairment of goodwill for 2003 above the initial impairment of $5.7 million that was recorded in the second quarter of 2003, which was the result of continued revenue decline in our service segment. There were two valuations performed in 2003, the first was the request of new management coming in at the end of May 2003 in order to get a sense of the current condition of the company and the second was to conform with the annual valuation period.

Our assessment of goodwill is based on the requirements of Statement of Financial Accounting Standard (SFAS) No. 142, Goodwill and Other Intangible Assets, which requires management to estimate the fair value of our Company and its reporting units. Determination of fair value is dependent upon many factors including management s estimate of future cash flows, appropriate discount rates, identification and evaluation of comparable businesses and amounts paid in market transactions for the sale of comparable businesses. For goodwill, any one of a number of future events, including a continued telecommunication industry downturn, could cause us to conclude that impairment indicators exist and the carrying value of these assets cannot be recovered.

Impairment or Disposal of Long Lived Assets

Our assessment of impairment of long lived assets is based on the requirements of SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. This Statement requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net undiscounted cash flows expected to be generated by the asset. 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 to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

The company reviews annually for any potential impairment of its long lived assets. In 2003, we performed a review on our fixed assets, excluding buildings, and found them to be impaired. We recognized a $3.3 million write down on our machinery and equipment. We performed a review for 2004 and 2005 and found no significant decrease in the market price of the equipment, nor any significant adverse changes in the way they will be used, and we do not expect any large maintenance projects. For these reasons along with the continual period depreciation, we feel the machinery and equipment are valued appropriately.

In addition, we continually review our buildings for further impairment. In 2003, we reviewed our Galion, Ohio facilities and determined we had excess capacity. We then recorded an asset impairment charge of $1.1 million to reflect the assets held for sale at their estimated realizable values based upon market conditions. These two facilities which consist of a new manufacturing facility and a shell, corporate headquarters facility have remained for sale. A contract to sell the new manufacturing facility was signed and we recognized in September 2005 further impairment of the facility in the amount of $430 thousand. The final sale was completed in February of 2006. Upon the sale of the new manufacturing building, we hired an appraisal firm to determine the fair value of the remaining corporate headquarters shell. Based on the results of the appraisal, it was determined that the building was further impaired and we recognized an additional impairment of $1.17 million. The building will remain for sale and appears as assets held for sale in current assets.

The sale of the Denver facility, which was deemed impaired in 2003, was completed on October 31, 2005, and we paid off the associated industrial revenue bonds on December 1, 2005. We recognized an additional $146 thousand impairment on the Denver facility in October 2005.

Inventory Valuation

Inventories are stated at the lower of cost or market, with cost determined by the first-in, first-out method. Inventory costs consist of purchased product, internal and external manufacturing costs, and freight. We sell our products as component replacement parts or on a build-to-order basis that ships to the customer upon completion.

We continually review the inventory for obsolescence or excessive quantities and accrue accordingly. At a minimum, all part numbers are reviewed quarterly. Should a part number have no usage for a year, we will reserve 100% of the standard cost for those part numbers which will reduce the total gross inventory value. In addition, we review for excesses and reserve a percentage as appropriate of standard costs for any excesses that are greater than the last twelve month usage or two times future six month requirements, whichever is greater. For 2005, upon further review of our excess quantities, we determined that our 50% reserve on excesses was not sufficient. The same formula will continue to be used to determine the excesses quantities, but we will now reserve 100% of these quantities. This created a $1.2 million inventory change in estimate.

We also reviewed the inventory costs, per the Financial Accounting Standards Board (FASB) issued Statement No. 151, Inventory Costs, an amendment to Accounting Research Bulletin No. 43, Chapter 4,

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Inventory Pricing. Upon completion of the review, we are comfortable that there are no abnormal idle facility costs, freight or handling costs in the inventory valuation. SFAS No. 151 also requires the allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production statement for fiscal year 2006. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. We have adopted this statement and recognized a write down of $728 after a thorough review of all inventory costs. We believe that calculating the cumulative effect is impractical and may furnish results different from what they would have been had the newly adopted principle been used in prior periods. Therefore, the effect of the change was recognized as change on current year results of operations. The loss per common share impact of this change in principle, assuming no dilution, is $0.03.

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.

At December 31, 2005, we have net deferred tax assets of $0 attributable to a gross valuation allowance of 100%. This valuation allowance is based on the weight of available evidence that more likely than not, the deferred tax assets will not be realized. We base our estimate of deferred tax assets and liabilities on current tax laws and rates and, in certain cases, business plans, tax planning strategies and other expectations about future outcomes. Since the effect of a change in tax rates is recognized in earnings in the period when the changes are enacted, changes in existing tax laws or rates could affect actual tax results and future business results may affect the amount of deferred tax liabilities or the valuation of deferred tax assets over time.

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.

The decision to record a valuation allowance requires varying degrees of judgment based upon the nature of the item giving rise to the deferred tax asset. As a result of continued operating losses and uncertainty as to the timing of profitability in future periods, we have established a valuation allowance against the entire net deferred tax assets as it is more likely than not that the tax benefit of these items will not be realized. Should future taxable income be materially different from our estimates, changes in the valuation allowance could occur that would impact our tax expense in the future.

Results of Operations

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

	Years Ended December 31,		
	2005	**2004**	**2003**
Net sales	100.0%	100.0%	100.0%

Cost of goods sold	80.9	87.0	108.9
Impairment of product segment machinery and equipment			8.5
Inventory impairment			22.4
Gross margin	19.1	13.0	(39.8)
Operating expenses:			
Research, development and engineering	8.1	9.4	9.8
Selling, general and administrative	18.0	25.2	26.8
Impairment of service segment goodwill and other intangibles		19.0	14.8
Real estate impairment	4.1		3.1
	30.2	53.6	54.5

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	Years Ended December 31,		
	2005	2004	2003
Loss from operations	(11.1)	(40.6)	(94.3)
Loss from joint venture		(0.3)	
Loss from operations after joint venture	(11.1)	(40.9)	(94.3)
Interest income, net	0.3	0.5	0.2
Loss before income taxes and before cumulative effect of accounting change	(10.8)	(40.4)	(94.1)
Benefit (provision) for income taxes		1.5	(0.1)
Net loss before cumulative effect of accounting change	(10.8)	(38.9)	(94.2)
Impairment of goodwill			
Net loss	(10.8)%	(38.9)%	(94.2)%

Year Ended December 31, 2005 Compared to Year Ended December 31, 2004

Net Sales. Net sales increased $10.8 million, or 34.5%, to $42.4 million for the year ended December 31, 2005 from $31.6 million for the year ended December 31, 2004. This was in line with the telecom growth that the industry had experienced in 2005. The wireless carriers provided 62% of our revenues in 2005 as compared to 55% of revenues in 2004.

Net sales in our product segment increased by $10.0 million, with the result being $31.1 million for the year ended December 31, 2005 as compared to $21.1 million for year ended December 31, 2004. The upward trend we recognized in the product segment has continued through 2005 as our customers have further increased their CAPEX spending. As of December 31, 2005, our product backlog, which represents total dollar volume of firm sales orders not yet recognized as revenue, had decreased to $2.6 million from $3.5 million at December 31, 2004. We believe this decrease was temporary, as January and February of 2006 bookings have increased as compared to the same periods in 2005.

Net sales in our service segment increased by $0.9 million, resulting in $11.4 million for year ended December 31, 2005 as compared with $10.5 million for the year ended December 31, 2004. Again the increase was a reflection of the telecom industry increase in CAPEX spending. As of December 31, 2005, our service backlog, which represents total dollar volume of firm sales orders not yet recognized as revenue, was $1.0 million, remaining flat with December 31, 2004.

Gross Margin. Gross margin dollars increased $1.8 million to $5.9 million in 2005 as compared to a $4.1 million in 2004. Gross margin as a percentage of net sales increased slightly to 13.8% in 2005 compared to 13.0% in 2004.

The product gross margin increased to $4.6 million in 2005 as compared to 2004 which had $3.4 million. The increase in product sales volume was the primary attribute in the increased product gross margin as the volume increase has a positive impact on absorption. Gross margin as a percentage of product sales decreased to 14.7% in 2005, which includes the inventory impairment, compared to a 16.1% in 2004.

The service segment gross margin increased to $1.3 million in 2005 as compared with the 2004 of $714 thousand. Service gross margin as a percentage of sales was 11.4% in 2005 as compared to 6.8% in 2004.

Research, Development and Engineering. Research, development and engineering expense increased to $3.4 million in 2005 from $3.0 million in 2004, representing an increase of $490 thousand. As a percentage of net product sales, research, development and engineering expense decreased to 11.1% in 2005 from 14.0% in

2004. This percentage decrease was due to the increased sales volume. The research, development and engineering expense increase was largely due to the focus on growth in the wireless market and the development on midsize products. The majority of these new products require Network Equipment Building Standards (NEBS) testing as specified by our customers. This testing is very expensive, which is impacting our R&D expenses.

Selling, General and Administrative. Selling, general and administrative expense decreased to $7.7 million in 2005 from $8.0 million in 2004, representing a decrease of $299 thousand. As a percentage of net sales, selling, general and administrative expense decreased to 18.0% in 2005 from 25.2% in 2004. This percentage decrease was due to increased sales volumes.

Interest Income. Interest income, net, was $178 thousand in 2005 compared to $149 thousand in 2004. The increase in interest income, net, in the current year was due primarily to the increase in interest rates and reduction of debt over the course of the year.

Income Taxes. As a result of our significant continued operating losses in recent years, we determined a valuation allowance for our net deferred tax assets was required. As such, our effective income tax rate was 0.2% in 2005, compared to an effective rate of 3.6% in 2004.

Year Ended December 31, 2004 Compared to Year Ended December 31, 2003

Net Sales. Net sales declined $7.0 million, or 18.2%, to $31.6 million for the year ended December 31, 2004 from $38.6 million for the year ended December 31, 2003. A 2.9% increase in product net sales was not enough to overcome a 42% decrease in services net sales. We believe this decline primarily was attributable to our customers being slow to react to their announced increases in CAPEX spending in the first two quarters of 2004.

Net sales in our product segment increased by $579 thousand to $21.1 million for the year ended December 31, 2004 as compared to $20.5 million for year ended December 31, 2003. As of December 31, 2004, our product backlog, which represents total dollar volume of firm sales orders not yet recognized as revenue, had increased to $3.5 million from $596 thousand at December 31, 2003.

Net sales in our service segment decreased by $7.6 million, which resulted in $10.5 million for year ended December 31, 2004 as compared with $18.1 million for year ended December 31, 2003. This decrease was due to the loss of a customer as a result of local service competition that is cropping up across the country. As of December 31, 2004, our service backlog, which represents total dollar volume of firm sales orders not yet recognized as revenue, had decreased to $1.0 million from $1.6 million at December 31, 2003.

Gross Margin. Gross margin dollars increased $19.5 million to a positive margin of $4.1 million in 2004 as compared to a negative margin of $15.4 million in 2003. Gross margin as a percentage of net sales increased to a positive 13.0% in 2004 compared to a negative 39.8% in 2003. A significant increase in both product margins and service margins from 2003 to 2004 contributed to the overall increase in gross profit margin.

The product gross margin increased to a positive $3.4 million in 2004 as compared to 2003 which had a negative $12.1 million. This increase was attributable primarily to increased product sales volume, a focus on product cost reductions, and increased absorption. We improved product standard margins via cost reductions, which resulted in a 1% improvement in 2004 to 32% as compared to 31% in 2003. In addition, we had $3.0 million of additional absorption in 2004 as compared to 2003. We did not recognize any impairment in 2004, while 2003 s gross margin reflected an $8.6 million inventory impairment charge along with a $3.3 million machinery and equipment impairment charge. Gross margin as a percentage of product sales increased to 16.1% in 2004 compared to a negative 59.3% in 2003, which includes impairments.

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The service segment gross margin increased to a positive $714 thousand in 2004 as compared with the 2003 negative gross margin of $3.2 million. Our new project management structure for services positively impacted the 2004 gross margin along with the loss of a customer mentioned in the net sales comparison above. Service gross margin as a percentage of sales was a positive 6.8% in 2004 as compared to a negative 17.8% in 2003.

Research, Development and Engineering. Research, development and engineering expense decreased to $3.0 million in 2004 from $3.8 million in 2003, representing a decrease of $830 thousand. In prior periodic reports on Form 10-K, we have measured R&D expenditures as a percentage of total sales. Ideally, R&D should be compared to product sales only and we have included this change for 2004 and will continue going forward. As a percentage of net product sales, research, development and engineering expense decreased to 14.0% in 2004 from 18.5% in 2003. This percentage decrease was largely the result of the continued effort to reduce expenses along with the more efficient design of flexible, modular power. This modularity concept was starting to show some financial results. Fourth quarter 2004 research, development, and engineering expenses were $772 thousand, compared to $708 thousand in the fourth quarter 2003. This represents a 9.0% increase.

Selling, General and Administrative. Selling, general and administrative expense decreased to $8.0 million in 2004 from $10.4 million in 2003, representing a decrease of $2.4 million. As a percentage of net sales, selling, general and administrative expense decreased to 25.2% in 2004 from 26.8% in 2003. This percentage decrease was a result of the continued effort to align expenses to revenue by way of cost cutting efforts.

Interest Income. Interest income, net, was $149 thousand in 2004 compared to $91 thousand in 2003. The increase in interest income, net, in the current year was due primarily to the increase in interest rates over the course of the year.

Income Taxes. As a result of our significant operating losses in 2004 and 2003, we determined a valuation allowance for our net deferred tax assets was required. As such, our effective income tax rate was 3.6% in 2004, compared to an effective rate of 0.1% in 2003.

Liquidity and Capital Resources

Our primary liquidity needs for the foreseeable future will be for working capital and operations. As of December 31, 2005, available cash and cash equivalents approximated $8.8 million. Based on available funds, current plans and increasingly opportunistic business conditions, management believes that the Company s available cash, borrowings and amounts generated from operations, will be sufficient to meet the Company s 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 $23.6 million at December 31, 2005, which represented a working capital ratio of 3.6 to 1, compared to $23.8 million at December 31, 2004. Our investment in inventories and accounts receivables was $16.0 million and $15.8 million at December 31, 2005 and 2004, respectively. Our capital expenditures were $0.06 million, $0.2 million, and $0.3 million in 2005, 2004, and 2003, respectively. Our budgeted capital expenditures for 2006 are $0.6 million as we remain focused on conserving cash. Accounts receivable days sales outstanding stood at 51 days at December 31, 2005, as compared to 61 days at December 31, 2004. At December 31, 2005, inventory days on hand, which represents gross inventory excluding impairments or reserves, were 123 days, as compared to 286 days on hand at December 31, 2004.

Cash flows used by operating activities were $5.7 million in 2005, remaining flat with cash flows used by operating activities of $5.7 million in 2004. This use of cash was primarily the result of operating losses along with increases in accounts receivable and decreases in accounts payable. This was offset by an inventory decrease. We saw positive inflow of cash from investing activities resulting from the sale of the Denver, Co. facility. From financing activities, we also had a positive inflow as the restricted cash was released as a result of the sale of the Denver facility but the associated industrial revenue bonds were paid off netting to a positive result.

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In August 2001, we entered into adjustable rate industrial revenue bonds for $6.5 million from the County of Arapahoe, Colorado in connection with the opening of our Denver service center. The $2.0 million Series A Bonds bear interest at 2.2% at December 31, 2004. The $4.5 million Series B Bonds bear interest at 2.55% at December 31, 2004. We sold the Denver, Colorado facility on October 31, 2005 and paid off these bonds in December 2005.

In September 2001, the Board of Directors authorized the repurchase of up to one million common shares in the open market or in private transactions. As of December 31, 2001, we had acquired 408,000 shares at a cost of $1.6 million. During the second quarter of 2002, we acquired 181,112 shares at a cost of $600,000. On July 26, 2002, the Board approved a one million share increase in the program. During the third quarter of 2002, we acquired 795,600 shares at a cost of $1.5 million, and in the fourth quarter of 2002, we acquired 1,000 shares at a cost of $1,470. As of December 31, 2005, we had repurchased a total of 1,385,712 shares at an average price of $2.70 per share. If we decide to repurchase additional shares going forward, we will request authorization from the board. There were no additional shares repurchased in 2005 or 2004.

We have an agreement with National City Bank to provide all banking services and a $3.5 million line of credit. As collateral for the line of credit, the Company established a $3.5 million deposit account with the bank. The balance of the restricted cash at National City Bank is $3.7 million.

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.

We have capital lease agreements for computer, machinery and office equipment that expire through 2007. Future minimum annual lease payments required during the years ending in 2006 and 2007 are $121,000 and $389,000, respectively.

We have operating leases covering certain office facilities, and equipment that expire at various dates through 2009. Future minimum annual lease payments required during the years ending in 2006 through 2009 under non-cancelable operating leases having an original term of more than one year are $234,000, $181,000, $92,000 and $47,000, respectively.

The following table provides a summary of our debt obligations, capital lease obligations, operating lease payments, and certain other material purchase obligations as of December 31, 2005.

(In thousands)	**Total**	**2006**	**2007**	**2008**	**2009**	**After 2009**
Capital Lease Obligations (1)	510	121	389			
Operating Lease Payments (2)	554	234	181	92	47	
Other Purchase Obligations	38	38				
Total	$ 1,102	$ 393	$ 570	$ 92	$ 47	$

(1)

The present value of these obligations, excluding interest, is included on our Consolidated Balance Sheets. See Note 6 of the Notes to Consolidated Financial Statements for additional information about our capital lease obligations.

(2) Our operating lease obligations are described in Note 6 of the Notes to Consolidated Financial Statements. A portion of these obligations is backed by a letter of credit totaling $78,000 at December 31, 2005, which expires on October 31, 2006.

Impact of New Accounting Standards

In November 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 151, Inventory Costs, an amendment to Accounting Research Bulletin No. 43, Chapter 4, Inventory Pricing. This

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statement clarifies that abnormal amounts of idle facility expense, freight, handling costs and wasted material should be recognized as current period charges. The provisions of this statement become effective for fiscal years beginning after June 15, 2005. SFAS No. 151 also requires the allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production statement for fiscal year 2006. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. We have adopted this statement and recognized a write down of $728 thousand after a thorough review of fixed costs.

In December 2004, FASB issued Statement No. 123R, Share Based Payment, a revision of Statement No. 123, Accounting for Stock Based Compensation and superseding APB Opinion No. 25, Accounting for Stock Issued to Employees. Statement 123R requires the Company to expense grants made under the stock option and employee stock purchase plans. Statement 123R is effective for the first interim or annual period beginning after July 15, 2005. Upon adoption of Statement 123R, amounts previously disclosed under Statement No. 123 will be recorded in the consolidated statement of operations. Consistent with the provisions of the new standard, the Company intends to adopt Statement 123R in the first quarter of 2006. The Company currently measures compensation costs related to its share-based awards under APB 25, as allowed by Statement 123. Information about the fair value of stock options under the Black Scholes model and its pro forma impact on the Company s net loss and loss per share can be found in Note 1 to the financial statements.

Off-Balance Sheet Financings

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 QUALITATIVEAND QUANTITATIVE DISCLOSURE ABOUT MARKET RISK

We are exposed to the impact of interest rate changes and, to a lesser extent, foreign currency fluctuations. We have not entered into interest rate or foreign currency transactions. Our foreign currency exposure was immaterial as of December 31, 2005, 2004 and 2003.

Our primary interest rate risk exposure results from our revolving line of credit facility. We had $1.4 million borrowings under this facility at December 31, 2005. We currently do not hedge our exposure to floating interest rate risk.

Forward-Looking Statements

We are making this statement in order to satisfy the safe harbor provisions contained in the Private Securities Litigation Reform Act of 1995. This Annual Report on Form 10-K includes forward-looking statements relating to our business, which involve risks and uncertainties. Forward-looking statements contained herein or in other statements made by us are made based on our management s expectations and beliefs concerning future events impacting us and are subject to uncertainties and factors relating to our operations and business environment, all of which are difficult to predict and many of which are beyond our control, that could cause our actual results to differ materially from those matters expressed or implied by forward-looking statements. We believe that the following factors, among others, could affect our future performance and cause our actual results to differ materially from those expressed or implied by forward-looking statements made by us or on our behalf:

general economic, business and market conditions;

competition;

decreases in spending by our communications industry customers;

consolidation in the telecommunication industry;

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- the loss of a major customer or customers;
- our ability to identify, consummate and integrate the operations of suitable acquisition targets;
- the impact of changing global, political and economic conditions;
- our ability to expand our international operations;
- our relations with our employees;
- our ability to meet the high standards of quality and reliability that communications service providers expect from communications equipment suppliers;
- variability in our operating results;
- our ability to attract and retain key personnel;
- our ability to keep up with the rapid technological changes, evolving industry standards, changing customer needs and frequent new equipment and service introductions in the communications industry; and
- our ability to protect our proprietary information.

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ITEM 8 FINANCIALSTATEMENTS AND SUPPLEMENTARY DATA

PECO II, INC.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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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 sheet of PECO II, Inc. and subsidiaries as of December 31, 2005, and the related consolidated statements of operations, shareholders equity, and cash flows for the year 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 audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether 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 audit 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 audit provides 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, 2005, and the results of their operations and their cash flows for the year ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America.

As described in Note 1 to the consolidated financial statements, the Company changed its method of accounting for inventory costing in 2005 to conform to Statement of Financial Accounting Standards No. 151.

/s/ BATTELLE & BATTELLE LLP

Dayton, Ohio

March 3, 2006

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders

PECO II, Inc.:

We have audited the accompanying consolidated balance sheet of PECO II, Inc. and subsidiaries as of December 31, 2004, and the related consolidated statements of operations, shareholders equity, and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides 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, 2004, and the results of their operations and their cash flows for the year ended December 31, 2004, in conformity with U.S. generally accepted accounting principles.

/s/ KPMG LLP

Columbus, Ohio
March 30, 2005

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Report of Independent Registered Public Accounting Firm

To the Shareholders and Board of Directors of PECO II, Inc.

We have audited the accompanying consolidated statements of operations, shareholders equity, and cash flows of PECO II, Inc. (an Ohio Corporation) for the year ended December 31, 2003. 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 audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether 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 audit 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 also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the results of operations, shareholders equity and cash flows of PECO II, Inc. for the year ended December 31, 2003 in conformity with accounting principles generally accepted in the United States of America.

/s/ GRANT THORNTON LLP

Cleveland, Ohio

January 28, 2004

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PECO II, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands, except share data)

	December 31,	
	2005	**2004**
ASSETS		
Current assets:		
Cash and cash equivalents	$ 8,778	$ 9,723
Accounts receivable, net	6,877	5,764
Inventories, net	9,112	10,031
Prepaid expenses and other current assets	732	527
Assets held for sale	3,518	4,136
Restricted cash	3,683	9,722
Total current assets	32,700	39,903
Property and equipment, at cost:		
Land and land improvements	195	254
Buildings and building improvements	4,608	10,363
Machinery and equipment	9,072	9,255
Furniture and fixtures	5,853	6,237
	19,728	26,109
Less-accumulated depreciation	(13,904)	(13,832)
Property and equipment, net	5,824	12,277
Other assets:		
Goodwill	1,774	1,774
Long term notes receivable		11
Investment in joint venture	6	16
Total assets	$ 40,304	$ 53,981
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Industrial revenue bonds	$	$ 5,860
Borrowings under line of credit	1,419	992
Capital leases payable	92	87
Accounts payable	1,880	2,537
Accrued compensation expense	1,106	1,227
Accrued income taxes	144	145
Other accrued expenses	4,455	5,255
Total current liabilities	9,096	16,103

Capital leases payable, net of current portion	354	448
Shareholders equity:		
Common shares, no par value: authorized 50,000,000 shares; 22,201,666 shares issued at December 31, 2005 and 2004	2,816	2,816
Additional paid-in capital	109,978	110,251
Accumulated deficit	(81,420)	(74,597)
Treasury shares, at cost, 346,925 and 635,364 shares at December 31, 2005 and 2004, respectively	(520)	(1,040)
Total shareholders equity	30,854	37,430
Total liabilities and shareholders equity	$ 40,304	$ 53,981

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,		
	2005	**2004**	**2003**
Net sales:			
Product	$ 31,059	$ 21,049	$ 20,470
Services	11,388	10,515	18,137
	42,447	31,564	38,607
Cost of goods sold:			
Product	26,487	17,660	20,682
Services	10,088	9,801	21,357
Impairment of product segment machinery and equipment			3,300
Inventory impairment			8,633
	36,575		