HEI, Inc.
Annual Report
Fiscal Year 2009

12 Months of Fiscal Year 2009
Compared to 16 Months of Fiscal Year 2008
and 12 Months of Fiscal Year 2007

	Page No.
Independent Auditors' Report	3
Report of Independent Registered Public Accounting Firm	4
Consolidated Balance Sheets	5
Consolidated Statements of Operations	6
Consolidated Statements of Changes in Shareholders' Equity	7
Consolidated Statements of Cash Flows	8
Notes to Consolidated Financial Statements	9-26

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INDEPENDENT AUDITORS' REPORT

To the Shareholders, Audit Committee and Board of Directors
HEI, Inc. and subsidiaries
Victoria, MN

We have audited the accompanying consolidated balance sheets of HEI, Inc. and subsidiaries as of January 2, 2010 and January 3, 2009 and the related consolidated statements of operations, changes in shareholders' equity and cash flows for the fiscal year and 16 months then ended, respectively. 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 audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the 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 audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of HEI, Inc. and subsidiaries as of January 2, 2010 and January 3, 2009 and the results of their operations and their cash flows for the fiscal year and 16 months then ended, in conformity with U.S. generally accepted accounting principles.

Baker Tilly Virchow Krause, LLP

Minneapolis, Minnesota
April 9, 2010

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders, Audit Committee and Board of Directors
HEI, Inc. and subsidiaries
Victoria, MN

We have audited the accompanying consolidated statements of operations, changes in shareholders' equity and cash flows of HEI, Inc. and subsidiaries for the fiscal year ended September 1, 2007. 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 consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of its 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 consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management as well as evaluating the overall consolidated 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 and cash flows of HEI, Inc. and subsidiaries for the fiscal year ended September 1, 2007 in conformity with U.S. generally accepted accounting principles.

Baker Tilly Virchow Krause, LLP

Minneapolis, Minnesota
November 30, 2007

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HEI, INC.
CONSOLIDATED BALANCE SHEETS

	January 2, 2010	January 3, 2009
	(In thousands, except share and per share data)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ -	$ 7
Accounts receivable, net of allowance for doubtful accounts of $130 and $77, respectively	3,566	4,686
Inventories, net	2,952	3,474
Deferred income taxes	362	435
Other current assets	455	835
Total current assets	7,335	9,437
Property and equipment:		
Land	216	216
Building and improvements	4,337	4,327
Fixtures and equipment	24,140	23,964
Accumulated depreciation	(23,025)	(21,590)
Net property and equipment	5,668	6,917
Security deposit	230	528
Other long-term assets	388	408
Total assets	$ 13,621	$ 17,290
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Checks issued in excess of cash in bank	$ 395	$ 509
Current maturities of long-term debt	551	1,026
Accounts payable	1,750	1,434
Customer deposit liabilities	228	73
Accrued liabilities	945	1,391
Total current liabilities	3,869	4,433
Deferred income taxes	362	435
Other long-term liabilities, less current maturities	1,934	1,870
Long-term debt, less current maturities	4,240	5,923
Total other long-term liabilities, less current maturities	6,536	8,228
Total liabilities	10,405	12,661
Shareholders' equity:		
Undesignated stock; 5,000,000 shares authorized; none issued	-	-
Convertible preferred stock, $.05 par; 167,000 shares authorized; 32,000 shares issued and outstanding; liquidation preference at $26 per share (total liquidation preference $832,000)	2	2
Common stock, $.05 par; 20,000,000 shares authorized; 10,183,000 and 10,374,000 shares issued and 9,720,000 and 9,630,000 outstanding	486	482
Paid-in capital	28,096	27,955
Accumulated deficit	(25,368)	(23,810)
Total shareholders' equity	3,216	4,629
Total liabilities and shareholders' equity	$ 13,621	$ 17,290

The accompanying notes are an integral part of the consolidated financial statements

HEI, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS

	Fiscal Periods Ended		
	12 months January 2, 2010	16 months January 3, 2009	12 months September 1, 2007
	(In thousands, except share and per share data)		
Net sales	$ 31,530	$ 55,751	$ 38,384
Cost of sales	26,734	45,183	36,817
Gross profit	4,796	10,568	1,567
Operating expenses:			
Selling, general and administrative	5,074	7,212	5,653
Research, development and engineering	805	1,658	2,330
Operating income (loss)	(1,083)	1,698	(6,416)
Interest expense	(445)	(836)	(1,312)
Other income (expense), net	(30)	211	540
Income (loss) from continuing operations before income taxes	(1,558)	1,073	(7,188)
Income tax provision	-	-	-
Income (loss) from continuing operations	(1,558)	1,073	(7,188)
Loss from discontinued operations	-	-	(217)
Gain on sale of discontinued operations	-	-	1,748
Net income (loss)	$ (1,558)	$ 1,073	$ (5,657)
Income (loss) per common share — basic and diluted:			
Continuing operations	$ (0.16)	$ 0.11	$ (0.75)
Discontinued operations	-	-	0.16
Net income (loss)	$ (0.16)	$ 0.11	$ (0.59)
Weighted average common shares outstanding:			
Basic and diluted	9,699,000	9,575,000	9,522,000

The accompanying notes are an integral part of the consolidated financial statements

HEI, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

	Common Stock Shares Outstanding	Common Stock	Convertible Preferred Stock Shares Outstanding	Convertible Preferred Stock	Additional Paid-In Capital	Accumulated Deficit	Related Party—Notes Receivable	Total Share-Holders' Equity
	(In thousands, except share data)							
Balance September 2, 2006	9,504,000	$ 475	32,000	$ 2	$ 27,581	$ (19,226)	$ (68)	$ 8,764
Net loss	-	-	-	-	-	(5,657)	-	(5,657)
Payments on former director loan	-	-	-	-	-	-	51	51
Write-off of former director loan	-	-	-	-	-	-	17	17
Stock based compensation expense	-	-	-	-	185	-	-	185
Issuance of common shares under stock benefit plans and option plans	39,000	3	-	-	(3)	-	-	-
Balance September 1, 2007	9,543,000	478	32,000	2	27,763	(24,883)	-	3,360
Net income	-	-	-	-	-	1,073	-	1,073
Stock based compensation expense	-	-	-	-	196	-	-	196
Issuance of common shares under stock benefit plans and option plans	87,000	4	-	-	(4)	-	-	-
Balance January 3, 2009	9,630,000	482	32,000	2	27,955	(23,810)	-	4,629
Net loss	-	-	-	-	-	(1,558)	-	(1,558)
Stock based compensation expense	-	-	-	-	145	-	-	145
Issuance of common shares under stock benefit plans and option plans	90,000	4	-	-	(4)	-	-	-
Balance January 2, 2010	9,720,000	$ 486	32,000	$ 2	$ 28,096	$ (25,368)	$ -	$ 3,216

The accompanying notes are an integral part of the consolidated financial statements

HEI, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Fiscal Period Ended		
	12 months January 2, 2010	16 months January 3, 2009	12 months September 1, 2007
	(In thousands, except share and per share data)		
Cash flow from operating activities:			
Net income (loss)	$ (1,558)	$ 1,073	$ (5,657)
Adjustments to reconcile net income (loss) to cash flow from operating activities:			
Depreciation and amortization	2,005	2,234	1,989
Change in accounts receivable allowance	53	(29)	(18)
(Gain) loss on disposal of property and equipment	43	(51)	4
Gain on sale of discontinued operations	-	-	(1,748)
Write off of former director loan	-	-	17
Stock based compensation expense	145	196	185
Changes in operating assets and liabilities:			
Accounts receivable	1,067	(208)	4,211
Inventories	522	(214)	3,108
Other current assets	308	(561)	(25)
Accounts payable	316	(1,781)	(199)
Customer deposit liabilities	155	42	-
Accrued liabilities	(382)	82	(569)
Net cash flow provided by operating activities	2,674	783	1,298
Cash flow from investing activities:			
Additions to property and equipment	(560)	(3,024)	(451)
Proceeds from the sale of assets	5	52	177
Additions to patents	(38)	(50)	(10)
Security deposit	-	-	24
Proceeds from sale of discontinued operations	-	-	2,953
Net cash flow provided by (used in) investing activities	(593)	(3,022)	2,693
Cash flow from financing activities:			
Checks written in excess of cash in bank	(114)	318	191
Officer/former director note repayment	-	-	51
Payment of debt issuance costs	(51)	-	(118)
Repayment of long-term debt	(1,910)	(1,125)	(1,121)
Proceeds from long-term debt	2,029	1,233	2,457
Net proceeds (repayments) of long-term debt - revolving line of credit	(2,042)	1,643	-
Net borrowings (repayments) on line of credit	-	-	(5,948)
Net cash flow provided by (used in) financing activities	(2,088)	2,069	(4,488)
Net increase (decrease) in cash and cash equivalents	(7)	(170)	(497)
Cash and cash equivalents, beginning of year	7	177	674
Cash and cash equivalents, end of year	$ -	$ 7	$ 177
Supplemental disclosures of cash flow information:			
Interest paid	$ 446	$ 803	$ 1,269

Supplemental disclosures of non-cash financing and investing activities:

In Fiscal 2009, 2008 and 2007, the Company issued common stock for vested restricted stock awards of $4, $4 and $3, respectively

During Fiscal 2009, the Company utilized $298 of its security deposits towards the buy-out of select capital leases

During Fiscal 2009, the Company acquired an asset that was under a capital lease for $63 that was financed by the lessor over a 12-month period

The accompanying notes are an integral part of the consolidated financial statements

HEI, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
12 Months of Fiscal Year 2009 Ended January 2, 2010, 16 Months of Fiscal Year 2008 Ended January 3, 2009 and 12 Months of Fiscal Year 2007 Ended September 1, 2007

Note 1

Business

HEI, Inc. is referred to herein as "HEI," the "Company," "us," "we" or "our," unless the context indicates otherwise. We operate three facilities in North America in support of our globally based customers. We provide contract manufacturing solutions to customers through our flex and rigid-flex substrate and microelectronic assembly capabilities and our medical design and development and box build services. Our primary markets are medical, telecommunications, industrial, military and aerospace. We support our customers' products from initial product development and design through transitional and full-scale serial manufacturing to worldwide distribution and aftermarket support.

Fiscal 12 months in 2009, Fiscal 16 months in 2008 and Fiscal 12 months in 2007

During fiscal year 2008, HEI changed its fiscal year end to the Saturday closest to December 31. As a result, fiscal year 2009 ended January 2, 2010 and is a 12 month reporting period and is identified herein as Fiscal 2009. Fiscal year 2008 ended January 3, 2009 and is a 16 month reporting period and is identified herein as Fiscal 2008. During fiscal year 2006, the Company changed its fiscal year end to a 52 or 53 week period ending on the Saturday closest to August 31. Fiscal year 2007 ended September 1, 2007 and is a 12 month reporting period and is identified herein as Fiscal 2007.

Discontinued operations

The Company sold substantially all of the assets and liabilities of its Radio Frequency Identification ("RFID") business effective August 31, 2007. The divestiture, which occurred at the end of Fiscal 2007 was treated as a discontinued operation for the Company. All results of operations and assets and liabilities of RFID for Fiscal 2007 as presented has been restated and classified as discontinued operations. All references to the business are based on results of operations from continuing operations.

Summary of Significant Accounting Policies

Principles of Consolidation. The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant inter-company transactions and balances have been eliminated in consolidation.

Revenue Recognition. Revenue for manufacturing and assembly is recognized upon shipment to the customer which represents the point at which the risks and rewards of ownership have been transferred to the customer.

Our design and development contracts are typically discrete time and materials projects that generally do not involve separately priced deliverables. Development contract revenue is recognized ratably as development activities occur based on contractual per hour and material reimbursement rates. Development contracts are an interactive process with customers as different design and functionality is contemplated during the design phase. Upon reaching the contractual billing maximums, we defer revenue until contract extensions or purchase orders are received from customers. We occasionally have contractual arrangements in which part or all of the payment or billing is contingent upon achieving milestones or customer acceptance. For those contracts we evaluate whether the contract should be accounted using the completed contract method if the term of the arrangement is short-term or using the percentage of completion method for longer-term contracts.

The Company periodically collects taxes from customers to be remitted to governmental authorities. The Company's policy is to present taxes imposed on revenue-producing transactions on a net basis (excluded from revenues).

Cash Equivalents. The Company is operating under a revolving line of credit which funds our cash needs on a daily basis. We do not maintain cash balances as part of this arrangement other than small operating accounts. If the Company were to maintain cash on hand, we consider investments in all highly liquid debt instruments with original maturities of three months or less at date of purchase to be cash equivalents.

Accounts Receivable. The Company periodically reviews customers' payment and credit history as part of extending unsecured credit and establishes an allowance for uncollectible accounts based upon factors surrounding the credit risk of specific customers and other information. Credit risk on accounts receivable is minimized as a result of the diverse nature of the Company's customer base. Invoices are generally due 30 to 90 days after shipment. Accounts receivable that extend past their due date are considered past due. The Company does not accrue interest on past due accounts receivable. Receivables are written off only after all collection attempts have failed and are based on individual credit evaluation and specific circumstances of the customer. Accounts receivable are shown net of an allowance for uncollectible accounts of $130,000 and $77,000 at January 2, 2010 and January 3, 2009, respectively. During Fiscal 2009 the Company increased the allowance for uncollectable accounts by $53,000, net, and during Fiscal 2008, the Company reduced the allowance for uncollectible accounts by $29,000. Accounts receivable over 90 days past due were $82,000 (before offsetting credits) and $29,000 at January 2, 2010 and January 3, 2009, respectively.

Inventories. Inventories are stated at the lower of cost or market and include materials, labor, and overhead costs. Cost is determined using the first-in, first-out method (FIFO). A large portion of the inventory is purchased based upon forecasts and customer purchase orders. If there is a contractual arrangement with the customer, the excess or obsolete inventory is the customers' responsibility. Inventory reserves of $278,000 and $214,000 at January 2, 2010 and January 3, 2009, respectively, are established for excess and slow-moving inventory, which are netted against the inventory balances shown in the consolidated financial statements.

Property and Equipment. Property and equipment are stated at cost. Depreciation and amortization are provided on the straight-line method over the estimated useful lives of the property and equipment. The approximate useful lives of building and improvements are 10-39 years and fixtures and equipment are 3-10 years. Depreciation and amortization expense on property and equipment, including capital leases, for both continuing and discontinued operations was $1,824,000, $1,997,000 and $1,831,000 for the fiscal years ended January 2, 2010, January 3, 2009 and September 1, 2007, respectively.

Maintenance and repairs are charged to expense as incurred. Major improvements and tooling costs are capitalized and depreciated using the straight-line method over their estimated useful lives. The cost and accumulated depreciation of property and equipment retired or otherwise disposed of is removed from the related accounts, and any resulting gain or loss is credited or charged to operations.

Patents. External costs associated with patents are capitalized and amortized over 84 months or the remaining life of the patent, whichever is shorter. Amortization expense related to patents was $85,000, $117,000 and $88,000 for Fiscal 2009, 2008 and 2007, respectively. Amortization expense is expected to approximate $23,000, $16,000 and $10,000 in each of the next three fiscal years, respectively, at which time the patents will be fully amortized. The book value of the patents is as follows (included in other long-term assets):

	January 2, 2010	**January 3, 2009**
Patent asset balance	$680,000	$640,000
Less accumulated amortization	(631,000)	(546,000)
Net patent value	$49,000	$94,000

Impairment of Notes Receivable. The Company routinely performs an analysis as to the probability that a receivable is collectible. A note receivable is impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the note receivable agreement including scheduled interest payments. At the end of Fiscal 2007, the Company had written off the remaining balance of a note receivable from a former director as uncollectible. No notes receivable are recorded on the books of the Company at January 2, 2010.

Impairment of Long-lived and Intangible Assets. Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Determination of recoverability is based on the Company's judgment and estimates of undiscounted future cash flows resulting from the use of the assets and their eventual disposition. Measurement of an impairment loss for long-lived assets and certain identifiable intangible assets that management expects to hold and use is based on the fair value of the assets. The carrying values of assets determined to be impaired are reduced to their estimated fair values. Fair values of any impaired assets would generally be determined using a market or income approach.

Intangible assets are stated at fair value as of the date acquired less accumulated amortization. Amortization is calculated on a straight-line basis or another method that more fairly represents the utilization of the assets. The future economic benefit of the carrying values of intangible assets that are subject to amortization are tested for recoverability whenever events or changes in circumstances indicate the carrying value of an intangible asset may not be recoverable based on undiscounted cash flows or market factors, and an

impairment loss would be recorded in the period so determined. There were no asset impairments in Fiscal 2009, Fiscal 2008 or Fiscal 2007.

Research, Development and Engineering. The Company expenses all research, development and engineering costs as incurred.

Shipping and Handling. The Company includes shipping and handling revenue in net sales and shipping and handling costs in cost of sales.

Advertising. Advertising costs are charged to expense as incurred. Advertising costs were $41,000, $112,000 and $95,000 for the periods Fiscal 2009, Fiscal 2008 and Fiscal 2007, respectively, and are included in selling, general and administrative expense.

Income Taxes. The income tax (provision) benefit is computed on the basis of the various tax jurisdictions' income or loss before income taxes. Deferred income taxes reflect the tax effects of differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The Company uses judgment and assumptions to determine if valuation allowances for deferred income tax assets are required if realization is not likely by considering future market growth, forecasted operations, future taxable income, and the mix of earnings in the tax jurisdictions in which it operates.

The Company considers income taxes in each of the tax jurisdictions in which it operates in order to determine its effective income tax rate. Current income tax exposure is identified and temporary differences resulting from differing treatments of items for tax and financial reporting purposes are assessed. These differences result in deferred tax assets and liabilities, which are included in the Company's consolidated balance sheets. We assess the likelihood that our deferred tax assets will be recovered from future taxable income and record a valuation allowance to reduce our deferred tax assets to the amounts we believe to be realizable.Accordingly, the income tax provision in the consolidated statements of operations is impacted by changes in the valuation allowance. Significant management estimates and judgment are required in determining any valuation allowance recorded against net deferred tax assets. The Company accounts for uncertain tax positions by recording a liability for unrecognized tax benefits resulting from uncertain tax positions taken, or expected to be taken, in its tax returns.

Stock-Based Compensation. The Company adopted Statement of Financial Accounting Standards (SFAS) No. 123(R), "Share-Based Payment" (primarily codified under Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 718) on September 1, 2005, using the modified prospective method. Subsequently compensation expense is recognized in its consolidated statements of operations over the service period that the awards are expected to vest. The Company recognized expense for all stock-based compensation with graded vesting on a straight-line basis over the vesting period of the entire award. Stock-based compensation expense includes the estimated effects of forfeitures, which will be adjusted over the requisite service period to the extent actual forfeitures differ, or are expected to differ, from such estimates. Changes in estimated forfeitures will be recognized in the period of change and will also impact the amount of expense to be recognized in future periods. Determining the appropriate fair-value model and calculating the fair value of stock option awards at the grant date requires considerable judgment, including estimating stock price volatility and the expected term of options granted. The Company uses the Black-Scholes option valuation model to value employee stock option awards. The Company estimates stock price volatility based on daily averages of its historical volatility over a term approximately equal to the grant's estimated option life. The expected term of options and forfeiture rate assumptions are derived from historical data.

As of January 2, 2010, 325,800 stock options are outstanding. The Company estimates the forfeiture rate for stock options using 10% for key employees and 15% for non-key employees. Based on these valuations, we recognized compensation expense of $9,000 ($.00 per share) in Fiscal 2009 related to the amortization of the unvested portion of these options compared to $54,000 ($.01 per share) in Fiscal 2008 and compared to $125,000 ($0.01 per share) for Fiscal 2007. Stock based compensation expense for outstanding options as of January 2, 2010 is expected to approximate $3,000 for Fiscal 2010 at which time they will be fully amortized.

Stock based compensation expense related to the restricted stock was $136,000, $142,000 and $60,000 for Fiscal 2009, Fiscal 2008 and Fiscal 2007, respectively. As of January 2, 2010, 554,000 shares of restricted stock remain unvested. Stock based compensation expense for outstanding restricted stock as of January 2, 2010 is expected to approximate $73,000, $119,000, $185,000 and $98,000 in each of the next four fiscal years, respectively.

There were no options granted in the twelve months ended January 2, 2010, in the sixteen months ended January 3, 2009 or in the twelve months ended September 1, 2007. There were no restricted stock shares granted in the twelve months ended January 2, 2010. There were 819,000 restricted stock shares granted in the sixteen months ended January 3, 2009 and 29,000 restricted stock shares granted in the twelve months ended September 1, 2007.

Customer Deposits. Customer deposits result from cash received in advance of manufacturing or design and development services being performed.

Income (Loss) Per Common Share. Basic income (loss) per share ("EPS") is computed by dividing net income or loss by the weighted average number of common shares outstanding during each period. Diluted income (loss) per share are computed by dividing net income or loss by the weighted average number of common shares outstanding assuming the exercise of convertible preferred stock, dilutive stock options and warrants. The dilutive effect of the stock options, restricted stock and warrants is computed using the average market price of the Company's stock during each period under the treasury stock method. During periods of loss, convertible preferred stock, options, restricted stock and warrants are not dilutive and are thus excluded from the calculation.

Use of Estimates. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ significantly from those estimates.

Financial Instruments. The fair value of accounts receivable and accounts payable approximate their carrying value due to the short-term nature of these instruments. The fair market values of the Company's borrowings and other long-term liabilities outstanding approximate their carrying values based upon current market rates of interest.

Discontinued Operations: The sale of the Company's radio frequency identification ("RFID") business unit to a third party was completed on August 31, 2007 pursuant to the terms of an Asset Purchase Agreement dated August 30, 2007. The transaction involved the sale of substantially all of the assets and liabilities of RFID. The results of RFID are reported as a separate line in the consolidated statements of operations as "Loss from discontinued operations". The Company elected to not allocate consolidated interest expense to the discontinued operations where the debt is not directly attributed to or related to the discontinued operations. All of the financial information in the consolidated financial statements and notes to the consolidated financial statements reflect only the results of continuing operations.

Recently Issued Accounting Pronouncements:

Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles - On October 4, 2009, we adopted new accounting guidance related to accounting standards codification and the hierarchy of generally accepted accounting principles ("GAAP"). The new guidance will become the source of authoritative non-SEC authoritative GAAP. The guidance establishes a two-level GAAP hierarchy for nongovernmental entities: authoritative guidance and nonauthoritative guidance. Authoritative guidance consists of the Codification and, for SEC registrants, rules and interpretative releases of the Commission. Nonauthoritative guidance consists of non-SEC accounting literature that is not included in the Codification and has not been grandfathered. The new guidance, including the Codification, is effective for financial statements of interim and annual periods ending after September 15, 2009. As the Codification was not intended to change or alter existing GAAP, it did not have any impact on our consolidated financial statements.

Consolidation of Variable Interest Entities - On January 3, 2010, we plan to adopt new accounting guidance related to consolidation of variable interest entities. The new guidance addresses the effects of eliminating the qualified special purpose entity concept and responds to concerns about the application of accounting guidance related to the consolidation of variable interest entities, including concerns over the transparency of enterprises' involvement with variable interest entities. The new guidance is effective for fiscal years beginning after November 15, 2009. We do not expect the new guidance to have a material impact on the preparation of our consolidated financial statements.

Accounting for Transfers of Financial Assets - On January 3, 2010, we plan to adopt new accounting guidance related to accounting for transfers of financial assets. The new guidance eliminates the concept of a "qualified special-purpose entity," changes the requirements for derecognizing financial assets and requires additional disclosures in order to enhance information reported to users of financial statements by providing greater transparency about transfers of financial assets, including securitization transactions, and an entity's continuing involvement in and exposure to the risks related to transferred financial assets. The new guidance is effective for fiscal years beginning after November 15, 2009. We do not expect the new guidance to have a material impact on the preparation of our consolidated financial statements.

Subsequent events - Effective July 4, 2009, we adopted new guidance related to subsequent events. The new guidance requires all entities to evaluate subsequent events through the date that the financial statements are available to be issued and disclose in the notes the date through which the Company has evaluated subsequent events and whether the financial statements were issued or were

available to be issued on the disclosed date. The new guidance defines two types of subsequent events, as follows: the first type consists of events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet and the second type consists of events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. The new guidance is effective for interim and annual periods ending after June 15, 2009 and must be applied prospectively. The adoption of the new guidance did not have a material effect on our results of operations or financial position.

Disclosures About Derivative Instruments and Hedging Activities - On January 4, 2009, we adopted new accounting guidance related to disclosures about derivative instruments and hedging activities. The new guidance is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity's financial position, financial performance and cash flows. The new guidance also improves transparency about the location and amounts of derivative instruments in an entity's financial statements; how derivative instruments and related hedged items are accounted for; and how derivative instruments and related hedged items affect its financial position, financial performance and cash flows. The new guidance is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. The adoption of the new guidance did not have a material effect on our results of operations or financial position.

Noncontrolling Interests in Consolidated Financial Statements - On January 4, 2009, we adopted new accounting guidance related to noncontrolling interests on consolidated financial statements. The new guidance establishes accounting and reporting standards for noncontrolling interests in subsidiaries and for the deconsolidation of subsidiaries and clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. The new guidance also requires expanded disclosures that clearly identify and distinguish between the interests of the parent owners and the interests of the noncontrolling owners of a subsidiary. The new guidance is effective for fiscal years beginning on or after December 15, 2008. The adoption of the new guidance did not have a material effect on our results of operations or financial position.

Business Combinations - On January 4, 2009, we adopted new accounting guidance related to business combinations. The new accounting guidance establishes the principles and requirements for how an acquirer in a business combination: recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interests in the acquiree; recognizes and measures the goodwill acquired in the business combination or the gain from a bargain purchase; and determines what information should be disclosed in the financial statements to enable users of the financial statements to evaluate the nature and financial effects of the business combination. The new guidance is effective for fiscal years beginning on or after December 15, 2008. The adoption of the new guidance did not have a material effect on our results of operations or financial position.

Uncertainties in income taxes - On January 4, 2009, the Company adopted a new standard related to the accounting for uncertainty in income taxes. In accounting for uncertainty in income taxes, the Company recognizes the financial statement benefit of a tax position only after determining that the relevant tax authority would more likely than not sustain the position following an audit. For tax positions meeting the more likely than not threshold, the amount recognized in the financial statements is the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement with the relevant tax authority. As a result of the adoption, the Company did not recognize any cumulative changes in its provision for tax expenses.

Note 2

Liquidity and Capital Resources

	January 2, 2010	January 3, 2009	September 1, 2007
		(in thousands)	
Net cash provided by operating activities	$ 2,674	$ 783	$ 1,298
Net cash provided by (used in) investing activities	(593)	(3,022)	2,693
Net cash provided by (used in) financing activities	(2,088)	2,069	(4,488)

The Company's working capital was $3.5 million (current ratio of 1.9 to 1) at the end of fiscal 2009 as compared to $5.0 million (current ratio of 2.1 to 1) at the end of fiscal 2008. The Company was able to maintain consistency even with a net loss based on tight control of its balance sheet accounts and cost containment efforts.

Cash provided by operating activities was $2.7 million for fiscal 2009 as compared to $0.8 million for fiscal 2008. The increase was primarily due to tight control over our balance sheet even though the Company incurred losses as a result of reduced sales.

Cash used in investing activities in fiscal 2009 decreased to $0.6 million as compared to $3.0 million in 2008, primarily due to capital expenditures decreasing year-over-year by $2.4 million. Capital expenditures were higher in fiscal 2008 primarily relating to equipment for our Tempe, Arizona and Victoria, Minnesota operations to improve capacity and capabilities. Capital expenditures for the 2009, 2008, and 2007 fiscal years were $0.6 million, $3.0 million and $0.5 million, respectively. The Company expects capital expenditure payments for fiscal 2010 to be approximately $1.5 million to $2.5 million, primarily related to investment in new technology, increased capabilities and capacity for our Tempe, Arizona and Victoria, Minnesota operations.

Cash used in financing activities was $2.1 million in fiscal 2009 as compared to cash provided from financing activities of $2.1 million in fiscal 2008, and is primarily comprised of $2.0 million in net repayments of our revolving line of credit in Fiscal 2009 compared to $1.6 million in net borrowing under our revolving line of credit in Fiscal 2008.

We generated a net loss for the 12-month reporting period if Fiscal 2009 of ($1,558,000) compared to a net income for the 16-month reporting period of Fiscal 2008 of $1,073,000 and a net loss for the 12-month reporting period of Fiscal 2007 of ($5,657,000). The Company was impacted by several factors in Fiscal 2009. The economic downturn that affected many US companies negatively affected the demand for products from a number of our customers. In addition, the results reflect the impact of some pricing concessions we made in order to retain certain business for HEI and the discontinuation of certain products by some of our customers. Throughout the past three fiscal years, we have adjusted and realigned many of our costs to the extent possible. Although we saw the impact of the economy on our sales that resulted in the reported declines, we continued to pursue new customers and new programs and we have started to add new customers at all three of our operating sites.

On December 31, 2009, we entered into an amendment of our revolving line of credit facility ("RLOC") with Wells Fargo Business Credit ("Wells"). The revolving line of credit agreement was originally entered into by the Company and Wells on May 15, 2007 and has been amended from time to time based on our changing business conditions and changing business relationship with Wells. The current amendment was entered into as a result of our violation of our previous debt covenants that occurred in the third and fourth quarters of Fiscal 2009. The Company was in compliance with all of the debt covenants as of January 2, 2010.

On July 17, 2009, we undertook a substantial restructuring of the RLOC to include the refinancing of the mortgage of our Victoria, Minnesota facility that was previously held with Commerce Bank and to expand the financing of our capital expenditures with Wells. The refinancing reduced the interest rate for the Company and provided for the payoff of select capital leases at the time of the refinancing. At the time of the refinancing, Wells became the only long-term creditor of the Company other than for its operating leases. The RLOC has a maximum line amount of $6.0 million with a current maturity of May 15, 2012. The revolving credit facilities are secured by accounts receivable and inventories and a first mortgage position on the Company's Victoria, Minnesota production facility. There are also a series of term loans that are outlined below that are secured by the underlying assets that were financed by the advances. The interest rate on the revolving line of credit advances is 4.0% over the three month LIBOR rate ("LIBOR"). The interest on the real estate mortgage is 4.5% over LIBOR and term loans have an interest rate is 4.25% over LIBOR, except upon an event of default. As of January 2, 2010, the LIBOR rate was 0.25%. The credit facilities require a minimum interest charge of $150,000 per year and there is an unused line fee of 0.25% under the revolving credit facility.

As part of our RLOC, Thomas F. Leahy, the Company's Chairman of the Board, guaranteed the financing package in an amount not to exceed $4.0 million and provided collateral to secure the guarantee in the amount of $4.0 million. Mr. Leahy's collateral pledge was reduced during Fiscal 2008 to $3.35 million and to $1.3 million in Fiscal 2009. In return for the guarantee and collateral pledge, he is paid a guarantee fee on a monthly basis by the Company. The current guarantee fee is $2,400 per month based on the $1.3 million in collateral and the guarantee fee was $8,000 per month based on the $3.35 million in collateral.

These credit facilities with Wells contain customary affirmative and negative covenants. The financial covenants include a limitation on capital expenditures and a minimum debt service coverage ratio. The creation of indebtedness outside the credit facility, creation of liens, making of certain investments, sale of assets, and incurrence of debt are all either limited or require prior approval from Wells under those facilities. These credit facilities also contain customary events of default such as nonpayment, bankruptcy, and change in the Company's Chairman of the Board, which if they occur may constitute an event of default.

At January 2, 2010, our sources of liquidity consisted primarily of approximately $3.1 million of borrowing capacity under our revolving credit facility. Our liquidity, however, is affected by many factors, some of which are based on the normal ongoing operations of our business, the most significant of which include the timing of the collection of receivables, the level of inventories and capital expenditures.

Cash Requirements

The Company's cash requirements in fiscal 2010 will be primarily to fund operations, including capital spending and debt service. The Company believes that cash generated from operations and amounts available under its credit facility will be sufficient to meet its cash requirements for the next 12 months. The Company regularly reviews the availability and terms on which it might issue additional equity or debt securities in the public or private markets. However, the Company cannot assure that additional sources of financing would be available to the Company on commercially favorable terms should the Company's capital requirements exceed its cash available from operations and cash available under its credit facility.

Note 3

Other Financial Statement Data

The following provides additional information concerning selected consolidated balance sheet accounts at January 2, 2010 and January 3, 2009:

	Fiscal period ended	
	January 2, 2010	January 3, 2009
	(In thousands)	
Inventories:		
Purchased parts	$ 2,180	$ 2,935
Work in process	441	218
Finished goods	331	321
	$ 2,952	$ 3,474
Accrued liabilities:		
Employee related costs	$ 644	$ 865
Real estate taxes	35	78
Current portion of long-term liabilities	79	79
Warranty reserve	22	31
Deferred revenue	30	116
Other accrued liabilities	135	222
	$ 945	$ 1,391
Other long-term liabilities:		
Remaining sublease lease obligation	$ 382	$ 422
Unfavorable operating lease, net	393	433
Accrued lease expense	1,238	1,094
Total	2,013	1,949
Less current maturities	79	79
Total other long-term liabilities	$ 1,934	$ 1,870

Note 4

Warranty Obligations

Sales of our products are subject to limited warranty guarantees that typically extend for a period of twelve months from the date of manufacture. The Company offers extended warranty coverage on certain products it manufactures. If an extended warranty is purchased by a customer the Company recognizes revenue over the life of the warranty period and records the estimated warranty expense over the same period. Warranty terms are included in customer contracts under which we are obligated to repair, replace or refund the purchase price of any components or assemblies our customers deem defective due to workmanship or materials. We do, however, reserve the right to reject warranty claims where we determine that failure is due to normal wear, customer modifications, improper maintenance, or misuse. Warranty provisions are based on estimated returns and warranty expenses applied to current period revenue and historical warranty incidence over the preceding twelve-month period. Both the experience and the warranty liability are evaluated on an ongoing basis for adequacy. The following is a roll forward of the Company’s product warranty accrual for each of the past three fiscal periods:

(In thousands)	Balance at Beginning of Year	Provision and Accrual Adjustments	Claims	Balance at End of Year
Fiscal 2009	$ 31	$ (9)	$ -	$ 22
Fiscal 2008	$ 11	$ 20	$ -	$ 31
Fiscal 2007	$ 12	$ 7	$ 8	$ 11

Note 5

Long-Term Debt, including Revolving Line of Credit Facility

Our long-term debt consists of the following:

	Fiscal period ended	
	January 2, 2010	January 3, 2009
	(In thousands)	
Wells Fargo Business Credit mortgage payable in monthly installments of principal of $8 based on a ten-year amortization. The maturity date balloon payment of $1,103 coincides with the revolving line of credit facility which is currently May 2012; collateralized by our Victoria, Minnesota facility	$ 1,320	$ -
Commerce Bank mortgage payable in monthly installments of principal and interest of $11 based on a twenty-year amortization. The final balance of $1,039 was paid off with the refinancing of the facility with Wells Fargo Business Credit in July 2009	-	1,053
Wells Fargo Business Credit Term Loan #1 payable in monthly principal installments of $6 through May 2012 based on a 60 month amortization with a final payment of approximately $6 due in May 2012; collateralized by equipment located at our Tempe facility	164	227
Wells Fargo Business Credit Term Loan #2 payable in monthly principal installments of $7 based on a 60 month amortization. The maturity date balloon payment of $114 coincides with the revolving line of credit maturity date which is currently May 2012; collateralized by select equipment located at our Tempe and Victoria facilities	302	376
Wells Fargo Business Credit Term Loan #3 payable in monthly principal installments of $14 based on a 60 month amortization. The maturity date balloon payment of $277 coincides with the revolving line of credit maturity date which is currently May 2012; collateralized by select equipment located at our Tempe and Victoria facilities	678	830
Wells Fargo Business Credit Term Loan #4 payable in monthly principal installments of $11 based on a 60 month amortization. The maturity date balloon payment of $272 coincides with the revolving line of credit maturity date which is currently May 2012; collateralized by select equipment located at our Tempe and Victoria facilities	600	-
Wells Fargo Business Credit Revolving Line of Credit with a maturity of May 2012; available borrowing is based on advance rates of accounts receivable and certain inventories; collateralized by substantially all assets of the Company and additional collateral provided by Mr. Leahy, the Company's chairman	1,716	3,758
Capital lease obligation; payable in installments of $5 through February 2010; collateralized by certain machinery and equipment	11	705
Total	4,791	6,949
Less current maturities	551	1,026
Total long-term debt	$ 4,240	$ 5,923

On July, 17, 2009, we refinanced the mortgage on our 48,000 square foot Victoria, Minnesota facility with Wells Fargo Business Credit. The refinance was done in conjunction with the revision of our revolving line of credit facility ("RLOC") as outlined below. The refinancing reduced our interest rate from 7.5% to 4.75% at January 2, 2010 and allowed us to reduce the collateral pledged by Mr. Leahy. The previous mortgage was with Commerce Bank that had a balloon balance maturity of $1 million in September 2009.

On December 31, 2009, we entered into an amendment of our RLOC with Wells Fargo Business Credit ("Wells"). The revolving line of credit agreement was originally entered into by the Company and Wells on May 15, 2007 and has been amended from time to time based on our changing business conditions and changing business relationship with Wells. The current amendment was entered into as a result of our violation of our previous debt covenants that occurred in the third and fourth quarters of Fiscal 2009. The Company was in compliance with all of the debt covenants as of January 2, 2010.

On July 17, 2009, we undertook a substantial restructuring of the RLOC to include the refinancing of the mortgage of our Victoria, Minnesota facility that was previously held with Commerce Bank and to expand the financing of our capital expenditures with Wells. The refinancing reduced the interest rate for the Company and provided for the payoff of select capital leases at the time of the refinancing. At the time of the refinancing, Wells became the only long term creditor of the Company other than for its operating leases. The RLOC has a maximum line amount of $6.0 million with a current maturity of May 15, 2012. The revolving credit facilities are secured by accounts receivable and inventories and a first mortgage position on the Company's Victoria, Minnesota production facility. There are also a series of term loans that are outlined below that are secured by the underlying assets that were financed by the advances. The interest rate on the revolving line of credit advances is 4.0% over the three month LIBOR rate ("LIBOR"). The interest on the real estate mortgage is 4.5% over LIBOR and term loans have an interest rate is 4.25% over LIBOR, except upon an event of default. As of January 2, 2010, the LIBOR rate was 0.25%. The credit facilities require a minimum interest charge of $150,000 per year and there is an unused line fee of 0.25% under the revolving credit facility. At January 2, 2010, the availability under the revolving credit facility based on collateral was approximately $3.1 million.

During Fiscal 2007, 2008 and 2009, we entered into a series of term notes with Wells to finance select equipment purchases for our Victoria, Minnesota and Tempe, Arizona facilities. The term notes have principal and interest payments due monthly in various amounts based on 60 month amortization schedules. The maturity dates coincide with the RLOC with balloon payments due in varying amounts on that maturity date which is currently May 15, 2012. The interest rates are set at LIBOR plus 4.25%. As of January 2, 2010, the outstanding balance under all four term notes was $1,744,000 in the aggregate.

During Fiscal 2006, the Company entered into several capital lease agreements to fund the acquisition of machinery and equipment, primarily at our Tempe facility. Most of these leases were entered into with Commerce Financial Group and were secured by the equipment being leased and a secured interest in our Victoria building. All but one of these leases was paid off during Fiscal 2009 and the remaining principal amount of the remaining lease as of January 2, 2010 is $11,000 with an effective interest rate of 2.5% with the final payment due in February 2010. At the end of the leases, we exercised our options to purchase the equipment for $1 or at an agreed upon value which was between 15% and 20% of the original equipment cost.

Principal maturities of long-term debt at January 2, 2010, are as follows:

Fiscal Years Ending	**(In thousands)**
2010	$ 540
2011	540
2012	3,700
Total	$ 4,780

Future minimum capital lease payments are as follows for the fiscal years ending after January 2, 2010:

Fiscal Years Ending	(In thousands)
2010	$ 11
Total	11
Less: amount representing interest	-
Present value of future minimum lease payments	11
Less: current portion	(11)
Capital lease obligations, net of current portion	$ -

The book value of the capital leases are as follows:

	Fiscal period ended	
	January 2, 2010	January 3, 2009
	(In thousands)	
Capital lease asset balance	$ 69	$ 3,060
Less accumulated amortization	(29)	(1,650)
Net capital lease asset value	$ 40	$ 1,410

Note 6

Income Taxes

Income tax expense (benefit) for the fiscal periods ended January 2, 2010, January 3, 2009 and September 1, 2007, consisted of the following:

	Fiscal period ended		
	January 2, 2010	January 3, 2009	September 1, 2007
		(In thousands)	
Current:			
Federal	$ -	$ -	$ -
State	-	-	-
Deferred	-	-	-
Income tax expense (benefit)	$ -	$ -	$ -

Actual income tax expense (benefit) differs from the expected amount based upon the statutory federal tax rates as follows:

	Fiscal period ended		
	January 2, 2010	January 3, 2009	September 1, 2007
Federal statutory tax rate	-34.0%	34.0%	-34.0%
State income tax rate (net of federal tax effect)	-4.9%	4.9%	-5.2%
Change in valuation allowance	38.5%	-42.3%	40.3%
Other	0.4%	3.4%	-1.1%
Effective tax rate	0.0%	0.0%	0.0%

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and liabilities at January 2, 2010 and January 3, 2009 are as follows:

	Fiscal year ended	
	January 2, 2010	January 3, 2009
	(In thousands)	
Deferred tax assets (current):		
Receivables	$ 51	$ 30
Inventories	207	199
Accrued liabilities	104	206
	362	435
Deferred tax assets (long-term):		
Net operating loss carry-forward	11,029	10,537
Stock based compensation	40	22
Other	197	197
Gross deferred tax assets (long-term)	11,266	10,756
Less: Deferred tax assets valuation allowance	(10,898)	(10,298)
Net deferred tax assets (long-term)	368	458
Deferred tax liabilities (long-term):		
Property and equipment	(730)	(893)
Net deferred tax liabilities (long-term)	(730)	(893)
Net deferred tax asset	$ -	$ -

The Company has federal and state net operating loss carry-forwards at January 2, 2010, of approximately $29.7 and $12.7 million, respectively, which is available to reduce income taxes payable in future years. If not used, this carry-forward will expire in years 2021 through 2028. Under the Tax Reform Act of 1986, the utilization of this tax loss carry-forward may be limited as a result of significant changes in ownership.

The valuation allowance for deferred tax assets as of January 2, 2010 was $10,898,000 and as of January 3, 2009 was $10,298,000. The total valuation allowance for the fiscal period ended January 2, 2010 increased $600,000, for the fiscal period ended January 3, 2009 decreased $1,805,000 and increased by $2,282,000 for the fiscal period ended September 1, 2007. In assessing the recovery of the deferred tax asset, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income in the periods in which those temporary differences become deductible. Management considers the scheduled reversals of future deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment.

On January 4, 2009, the Company adopted a new standard related to the accounting for uncertainty in income taxes. In accounting for uncertainty in income taxes, the Company recognizes the financial statement benefit of a tax position only after determining that the relevant tax authority would more likely than not sustain the position following an audit. For tax positions meeting the more likely than not threshold, the amount recognized in the financial statements is the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement with the relevant tax authority. As a result of the adoption, the Company did not recognize any cumulative changes in its provision for tax expenses.

With few exceptions, the Company is no longer subject to U.S. federal, state or local income tax examinations by tax authorities for the years before 2006. The Company is not currently under examination by any taxing jurisdiction. In the event of any future tax assessments, the Company has elected to record the income taxes and any related interest and penalties as income tax expense on the Company's statement of operations.

Note 7

Stock Benefit Plans

1998 Plan. Under the Company's 1998 Stock Option Plan (the "1998 Plan"), a maximum of 2,000,000 shares of common stock was issuable pursuant to qualified and nonqualified stock options. Stock options granted become exercisable in varying increments with a portion tied to the closing stock price or up to a maximum of ten years, whichever comes first. The exercise price for options granted is equal to the closing market price of the common stock on the date of the grant. The 1998 Plan expired November 18, 2008. 225,800 shares were outstanding under the 1998 Plan at January 2, 2010.

1989 Plan. Under the Company's 1989 Omnibus Stock Compensation Plan (the "1989 Plan"), a maximum of 2,000,000 shares of common stock was issuable pursuant to qualified and nonqualified stock options, stock purchase rights and other stock-based awards. Stock options granted become exercisable in varying increments with a portion tied to the closing stock price or up to a maximum of ten years, whichever comes first. Generally, the exercise price for options granted is equal to the closing market price of the common stock on the date of the grant. Under the 1989 Plan, substantially all regular full-time employees are given the opportunity to designate up to 10% of their annual compensation to be withheld, through payroll deductions, for the purchase of common stock at 85% of the lower of (i) the market price at the beginning of the plan year, or (ii) the market price at the end of the plan year. No shares were purchased under the 1989 Plan in connection with the employee stock purchase plan during Fiscal 2008 or 2007. The 1989 Plan expired November 18, 2008. No shares were outstanding under the 1989 Plan at January 2, 2010.

Directors' Plan. During Fiscal 1999, the shareholders approved the 1998 Stock Option Plan for Non-employee Directors (the "Director's Plan"). Under the Director's Plan, 425,000 shares were authorized for issuance, with an initial year grant of 55,000 shares and an annual grant thereafter of 10,000 shares to each non-employee director. These grants were effective each year upon adjournment of the annual shareholders' meeting at an exercise price equal to the market price on the date of grant. The options become exercisable at the earlier of seven years after the grant date or on the first day the market value equals or exceeds $25.00. These options expire ten years after the grant date. No shares were issued under the Director's Plan during Fiscal 2008 or 2007. The Director's Plan expired November 18, 2008. 100,000 shares were outstanding under the Director's Plan at January 2, 2010.

2005 HEI, Inc. Employee Stock Purchase Plan. During Fiscal 2006, the shareholders approved the 2005 HEI, Inc. Employee Stock Purchase Plan, which included a total of 300,000 shares of the Company's Common Stock reserved for issuance under the Plan. The purpose of the Plan was to provide eligible employees with an opportunity to increase their proprietary interest in the success of the Company by purchasing Common Stock from the Company on favorable terms and paying for such purchases through periodic payroll deductions. No shares were purchased under this Plan in Fiscal 2006. The 2005 HEI, Inc. Employee Stock Purchase Plan was terminated effective December 31, 2006 as the Plan was never implemented and no shares were purchased under the Plan.

As of January 2, 2010, approximately 305,800 of the 325,800 outstanding options are fully vested and have expiration dates ranging from January 2010 through June 2015.

Summary of Activity. The following is a summary of all activity involving the above stock option plans:

	Options Outstanding	Weighted Average Exercise Price Per Share	Aggregate Intrinsic Value
Balance, September 2, 2006	1,336,975	$4.80	
Granted	-	-	
Exercised	-	-	
Cancelled	(453,650)	3.16	
Balance, September 1, 2007	883,325	$5.64	
Granted	-	-	
Exercised	-	-	
Cancelled	(519,625)	6.32	
Balance, January 3, 2009	363,700	$4.66	
Granted	-	-	
Exercised	-	-	
Cancelled	(37,900)	5.79	
Balance, January 2, 2010	325,800	$4.53	$0
Options exercisable	305,800	$4.61	$0

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based on the Company's closing stock price of $0.60 as of January 2, 2010, which theoretically could have been received by the option holders had all option holders exercised their options as of that date. There were no in-the-money options outstanding as of January 2, 2010.

Options that were exercisable as of January 2, 2010, January 3, 2009 and September 1, 2007 were 305,800, 331,450 and 712,606, respectively. The average exercise price of exercisable options at January 2, 2010, January 3, 2009 and September 1, 2007 was $4.56, $4.71 and $5.86, respectively. The weighted average remaining contractual life for options exercisable was 3.2 years at January 2, 2010.

The following table summarizes information about stock options outstanding as of January 2, 2010:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	**Number of Options**	**Weighted Average Exercise Price**	**Weighted Average Remaining Contractual Life**	**Number of Options**	**Weighted Average Exercise Price**
$1.68	50,000	$1.68	3.2	50,000	$1.68
$2.75-3.40	192,000	3.01	4.2	172,000	2.98
$5.95-7.70	46,600	7.14	2.0	46,600	7.14
$10.75-14.56	37,200	12.92	0.6	37,200	12.92
	325,800	$4.53	3.3	305,800	$4.61

There were no options granted in Fiscal 2009, 2008 or 2007.

Common Stock Warrants. In May, 2005, the Company issued five year warrants to purchase 527,152 shares of common stock at an exercise price of $3.05 in connection with a private equity offering and will expire May 2010 if not exercised. In February 2004, the Company issued five year warrants to purchase 424,800 share of common stock at an exercise price of $3.72 in connection with a private equity placement and these warrants expired, unexercised in February 2009.

Restricted Stock Awards. Restricted stock awards are awards of common stock that are subject to restrictions on transfer and to a risk of forfeiture if the awardee leaves the Company before the restrictions lapse. The holder of a restricted stock award is generally entitled at all times on and after the date of issuance of the restricted shares to exercise the rights of a shareholder of the Company, including the right to vote the shares and the right to receive dividends on the shares. The value of such stock was established by the

market price on the date of the grant. Compensation expense is being recorded over the applicable restricted stock vesting period, utilizing an estimated annual forfeiture rate of 15%. The Company has issued restricted stock to non-employee directors and certain members of the Company's management during the past three fiscal years with vesting periods that range from six months to five years. A summary of the Company's restricted stock activity is presented in the following table:

	Shares	Weighted Average Grant Date Fair Value	Weighted Average Remaining Contractual Term
Balance, September 2, 2006	58,800	$ 3.24	
Granted	28,570	1.40	
Vested	(38,320)	1.86	
Forfeited	(22,050)	3.32	
Unvested balance, September 1, 2007	27,000	$ 3.18	
Granted	819,289	0.99	
Vested	(86,723)	1.01	
Forfeited	(15,000)	3.30	
Unvested balance, January 3, 2009	744,566	$ 1.02	
Granted	-	-	
Exercised	(90,816)	1.01	
Cancelled	(100,000)	1.00	
Unvested balance, January 2, 2010	553,750	$ 1.02	3.48 years

As of January 2, 2010, there was $475,000 of total unrecognized compensation costs related to the outstanding restricted stock awards which is expected to be recognized over a weighted average period of 3.48 years.

Note 8

Net Income (Loss) Per Share Computation

The components of net income (loss) per basic and diluted share are as follows:

	Fiscal period ended		
	January 2, 2010	January 3, 2009	September 1, 2007
	(In thousands, except share data)		
Basic:			
Income (loss) from continuing operations	$ (1,558)	$ 1,073	$ (7,188)
Income (loss) from discontinued operations	-	-	(217)
Gain on sale of discontinued operations	-	-	1,748
Income (loss) attributable to common shareholders	$ (1,558)	$ 1,073	$ (5,657)
Income (loss) per common share:			
Continuing operations	$ (0.16)	$ 0.11	$ (0.75)
Discontinued operations	-	-	0.16
Net loss attributable to common shareholders	$ (0.16)	$ 0.11	$ (0.59)
Weighted average number of common shares outstanding	9,699,000	9,575,000	9,522,000

	Fiscal period ended		
	January 2, 2010	January 3, 2009	September 1, 2007
	(In thousands, except share data)		
Diluted:			
Income (loss) from continuing operations	$ (1,558)	$ 1,073	$ (7,188)
Income (loss) from discontinued operations	-	-	(217)
Gain on sale of discontinued operations	-	-	1,748
Income (loss) attributable to common shareholders	$ (1,558)	$ 1,073	$ (5,657)
Income (loss) per common share:			
Continuing operations	$ (0.16)	$ 0.11	$ (0.75)
Discontinued operations	-	-	0.16
Net income (loss) attributable to common shareholders	$ (0.16)	$ 0.11	$ (0.59)
Weighted average number of common shares outstanding	9,699,000	9,575,000	9,522,000
Effect of convertible preferred stock	-	-	-
Effect of dilutive stock options , restricted stock and warrants	-	-	-
Weighted average shares assuming dilution	9,699,000	9,575,000	9,522,000

Approximately 1,407,000, 2,060,000 and 1,835,000 shares under stock options, restricted stock and warrants have been excluded from the calculation of diluted net loss per common share as they are antidilutive for our fiscal periods ended January 2, 2010, January 3, 2009 and September 1, 2007, respectively.

Note 9

Equity Offerings

Sale of Convertible Preferred Stock

On May 9, 2005, we completed the sale of 130,538 shares of our Series A convertible preferred stock ("preferred stock") in a private placement to a group of institutional and accredited investors. Gross proceeds to us from the offering were $3.4 million. Each share of preferred stock is convertible into ten shares of our common stock, which in the aggregate would represent an additional 1,305,380 shares of common stock. Through January 2, 2010, 985,380 shares of common stock have been issued in connection with the conversion of 98,538 shares of convertible preferred stock.

The purchase price of the preferred stock was $26.00 per share. In connection with the financing, we also issued to the investors and the agent five-year warrants to purchase up to 527,152 shares of common stock at an exercise price of $3.05 per share. If the warrant holders exercise the warrants in full we would receive an additional approximately $1.6 million in cash proceeds. There are no dividend, coupon or redemption rights associated with our preferred stock; however our preferred stock includes a liquidation preference. The Convertible Preferred Shares have voting rights on an "as if" converted basis. We issued warrants to purchase 25,000 shares of our common stock at an exercise price of $3.05 per share as compensation to the placement agent who assisted in the private placement.

In the event that the Company liquidates or dissolves, the holders of each outstanding share of preferred stock will be entitled to receive an amount equal to $26.00 per share, plus any declared but unpaid dividends, in preference to the holders of our common stock or any other class of our capital stock ranking junior to our preferred stock. After the full payment of the preference amount to the holders of our preferred stock, and provision or payment of our debts and other liabilities, our remaining assets or property are distributable upon such liquidation and shall be distributed pro rata among the holders of our common stock. At January 2, 2010, there are two unconverted preferred shareholders.

Note 10

Guarantee by Related Party

In order to provide an inducement to Wells Fargo Business Credit to advance funds sufficient to pay off his outstanding loan while providing the Company with adequate working capital access under the revolving line of credit facility, Thomas F. Leahy, the Chairman of the Board of Directors of the Company, guaranteed the Wells financing package in an amount not to exceed $4 million and provided collateral to secure the guarantee in the amount of $4 million (subsequently reduced to $3.35 million in 2008 and further to $1.3 million in 2009). In return for the guarantee and collateral pledge, he is paid a guarantee fee on a monthly basis by the Company. The current guarantee fee is $2,400 per month based on the $1.3 million in collateral and the guarantee fee was $8,000 per month based on the $3.35 million in collateral. The total guarantee fee paid to Mr. Leahy for the 12-month period of Fiscal 2009, the 16-month period of Fiscal 2008 and the 12-month period of Fiscal 2007 was $73,000, $128,000 and $28,000, respectively and the guarantee fee is expected to continue for as long as the guarantee is in place. The Company cannot currently determine how long the guarantee will be in place.

Note 11

Employee Benefit Plans

The Company has a 401(k) plan covering all eligible employees. Employees can make voluntary contributions to the plan of up to 90% of their compensation not to exceed the maximum specified by the Internal Revenue Code. The plan also provides for a discretionary contribution by the Company. During our fiscal periods ended January 2, 2010, January 3, 2009 and September 1, 2007, the Company contributed $273,000, $194,000 and $196,000, respectively to the plan for both continuing and discontinued operations.

Note 12

Commitments and Contingencies

We lease an approximate 13,000 square foot production facility in Tempe, Arizona for our high density flexible substrate operations. The lease extends through July 31, 2010. Base rent is approximately $103,000 per year. We lease another approximately 4,000 square foot mixed office and warehouse space facility in Tempe, Arizona that is used for office and storage space in support of the Tempe operation. The lease coincides with the lease on the other Tempe space and terminates July 31, 2010. The base rent is approximately $36,000 per year. We are reviewing our options to extend the leases beyond their current expiration date. Both leases allow for the extension of the leases with various revised expiration dates.

We lease an approximate 152,000 square foot facility in Boulder, Colorado for our AMO segment operations. Our base rent is approximately $1,588,000 for Fiscal 2010. In addition to the base rent, we pay all operating costs associated with this building. The annual base rent increases each year by 3%. The Boulder facility is leased until September 2019. Currently, we occupy approximately 70,000 square feet of the facility and approximately 39,000 is vacant. In April 2005, we entered into a ten year sublease agreement for approximately 24,000 square feet with a high quality tenant. This is a ten year lease which provides for rental payments and reimbursement of operating costs. Aggregate rental and operating cost payments payable of approximately $281,000 per year commenced in November 2006. We have also subleased approximately 19,000 square feet of warehouse space to three additional tenants with agreements ranging from month-to-month to several years in length, which contribute approximately $58,000 on an annualized basis. We are continuing to look for sublease tenants for the remaining 39,000 square feet of vacant space.

Total rent expense for the periods ended January 2, 2010, January 3, 2009 and September 1, 2007 including common area costs and real estate taxes was $1,512,000, $2,470,000 and $1,967,000, respectively for both continuing and discontinued operations.

The operating lease and other contractual commitments, future minimum lease payments and excluding executory costs such as real estate taxes, insurance and maintenance expense, by year and in the aggregate are as follows:

Fiscal year ending	Minimum Operating Lease Commitments (In thousands)
2010	$ 1,682
2011	1,636
2012	1,685
2013	1,735
2014	1,788
Thereafter	9,246
Total minimum lease payments	$ 17,772

Note 13

Discontinued Operation and Sale of RFID Business Unit

On August 31, 2007, the Company completed the sale of the Company's RFID business unit ("RFID") to a third party. The Company acquired RFID in October 2001 and operated the business unit as part of its Microelectronics business. RFID provided radio frequency identification products to the industrial and consumer markets. All results of operations and assets and liabilities of RFID have been restated and classified as discontinued operations.

The sale of RFID was completed on August 31, 2007 pursuant to the terms of an Asset Purchase Agreement dated August 30, 2007. The transaction involved the sale of RFID for $3 million cash, including substantially all assets and liabilities of RFID at closing. The sales price was not subject to a price adjustment.

The gain on the sale of RFID is calculated as follows and reflected in the results for Fiscal 2007:

	(In thousands)
Cash received	$ 3,000
Less: Transferred assets, net of liabilities of RFID	(1,205)
Less: Transaction costs	(47)
Gain on sale	$ 1,748

Condensed consolidated statements of operations for RFID for fiscal year ended September 1, 2007 is as follows:

	(In thousands)
Net sales	$ 3,234
Gross profit	538
Selling, general and administrative	583
Research and development	183
Other income (expense), net	11
Income (loss) from discontinued operations	$ (217)

Depreciation expense for RFID was $127,000 for Fiscal 2007.

Note 14

Major Customers and Concentration of Credit Risk

The table below sets forth the approximate percentage of net sales to major customers that represented over 10% of our revenue:

	Fiscal Period Ended		
Customer	**January 2, 2010**	**January 3, 2009**	**September 1, 2007**
Customer A	15%	11%	10%
Customer B	14%	12%	6%
Customer C	12%	4%	0%
Customer D	12%	10%	11%
Customer E	1%	7%	14%
Total	54%	44%	41%

Accounts receivable from these customers represented 46% and 46% of the total trade accounts receivable at January 2, 2010 and January 3, 2009, respectively.

The Company generally sells its products to OEMs in the United States and abroad in accordance with supply contracts or purchase orders specific to certain manufacturer product programs. The Company performs ongoing credit evaluations of its customers' financial conditions and, generally, does not require collateral from its customers. The Company's continued sales to these customers are often dependent upon the continuance of the customers' product programs.

Note 15

Subsequent Events

The Company has performed an evaluation of subsequent events through April 9, 2010, which is the date these financial statements were issued. No additional disclosures were required based on this review by management.