

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended September 30, 2009

or

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: **0-31641**

**SCI ENGINEERED MATERIALS, INC.**

(Exact name of small business issuer as specified in its charter)

**Ohio**  
(State or other jurisdiction of  
incorporation or organization)

**31-1210318**  
(I.R.S. Employer  
Identification No.)

**2839 Charter Street, Columbus, Ohio 43228**  
(Address of principal executive offices) (Zip Code)

**(614) 486-0261**  
(Registrant's telephone number, including area code)

**Not Applicable**  
(Former name, former address and former fiscal year, if changed since last report)

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

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

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

3,562,259 shares of Common Stock, without par value, were outstanding at October 30, 2009.

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FORM 10-Q

SCI ENGINEERED MATERIALS, INC.

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**PART I. FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

**SCI ENGINEERED MATERIALS, INC.**

**BALANCE SHEETS**

	<u>September 30,</u> <u>2009</u>	<u>December 31,</u> <u>2008</u>
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash	\$ 827,694	\$ 1,399,050
Accounts receivable		
Trade, less allowance for doubtful accounts of \$15,753 and \$24,700	620,213	464,016
Contract	77,789	109,717
Other	16,496	3,423
Inventories	928,711	1,264,433
Prepaid expenses	427,764	42,562
Total current assets	<u>2,898,667</u>	<u>3,283,201</u>
<b>PROPERTY AND EQUIPMENT, AT COST</b>		
Machinery and equipment	5,011,703	4,192,516
Furniture and fixtures	107,998	107,998
Leasehold improvements	315,054	313,951
Construction in progress	19,453	144,682
	5,454,208	4,759,147
Less accumulated depreciation	<u>(2,799,841)</u>	<u>(2,469,030)</u>
	2,654,367	2,290,117
<b>OTHER ASSETS</b>		
Deposits	22,164	29,002
Intangibles	42,071	34,254
Total other assets	<u>64,235</u>	<u>63,256</u>
<b>TOTAL ASSETS</b>	<u>\$ 5,617,269</u>	<u>\$ 5,636,574</u>

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

SCI ENGINEERED MATERIALS, INC.

BALANCE SHEETS

LIABILITIES AND SHAREHOLDERS' EQUITY

	<u>September 30,</u> <u>2009</u>	<u>December 31,</u> <u>2008</u>
	(UNAUDITED)	
<b>CURRENT LIABILITIES</b>		
Capital lease obligation, current portion	\$ 368,843	\$ 285,408
Note payable, current portion	62,697	20,386
Accounts payable	412,667	249,309
Accrued contract expenses	-	52,525
Customer deposits	537,646	700,118
Accrued compensation	86,322	94,167
Accrued expenses and other	127,459	94,928
Total current liabilities	<u>1,595,634</u>	<u>1,496,841</u>
Capital lease obligation, net current portion	827,776	622,769
Note payable, net current portion	332,226	379,614
Total liabilities	<u>2,755,636</u>	<u>2,499,224</u>
<b>COMMITMENTS AND CONTINGENCIES</b>	<u>-</u>	<u>-</u>
<b>SHAREHOLDERS' EQUITY</b>		
Convertible preferred stock, Series B, 10% cumulative, nonvoting, no par value, \$10 stated value, optional redemption at 103%; 24,430 issued and outstanding	367,539	373,647
Common stock, no par value, authorized 15,000,000 shares; 3,562,259 and 3,560,259 shares issued and outstanding respectively	9,187,733	9,180,183
Additional paid-in capital	1,368,577	985,396
Accumulated deficit	<u>(8,062,216)</u>	<u>(7,401,876)</u>
	<u>2,861,633</u>	<u>3,137,350</u>
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<u>\$ 5,617,269</u>	<u>\$ 5,636,574</u>

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

SCI ENGINEERED MATERIALS, INC.

STATEMENTS OF OPERATIONS

THREE MONTHS ENDED SEPTEMBER 30, 2009 AND 2008  
AND NINE MONTHS ENDED SEPTEMBER 30, 2009 AND 2008  
(UNAUDITED)

	THREE MONTHS ENDED SEPT. 30,		NINE MONTHS ENDED SEPT. 30,	
	2009	2008	2009	2008
<b>SALES REVENUE</b>	\$ 2,028,355	\$ 3,959,286	\$ 4,738,869	\$ 7,150,618
<b>CONTRACT RESEARCH REVENUE</b>	196,401	49,349	697,475	89,470
	<u>2,224,756</u>	<u>4,008,635</u>	<u>5,436,344</u>	<u>7,240,088</u>
<b>COST OF SALES REVENUE</b>	1,481,956	3,218,620	3,651,003	5,552,257
<b>COST OF CONTRACT RESEARCH REVENUE</b>	190,501	20,449	556,532	51,393
	<u>1,672,457</u>	<u>3,239,069</u>	<u>4,207,535</u>	<u>5,603,650</u>
<b>GROSS PROFIT</b>	552,299	769,566	1,228,809	1,636,438
<b>MARKETING AND SALES EXPENSE</b>	178,107	169,524	492,557	441,556
<b>GENERAL AND ADMINISTRATIVE EXPENSE</b>	273,472	241,101	977,430	751,562
<b>RESEARCH AND DEVELOPMENT EXPENSE</b>	59,829	133,066	264,406	355,785
<b>INCOME (LOSS) FROM OPERATIONS</b>	<u>40,891</u>	<u>225,875</u>	<u>(505,584)</u>	<u>87,535</u>
<b>OTHER INCOME (EXPENSE)</b>				
Interest income	842	5,569	5,688	19,744
Interest expense	(26,834)	(27,490)	(84,057)	(79,487)
Financing expense	-	-	(76,387)	-
Gain on disposal of equipment	-	800	-	2,000
	<u>(25,992)</u>	<u>(21,121)</u>	<u>(154,756)</u>	<u>(57,743)</u>
<b>INCOME (LOSS) BEFORE PROVISION FOR INCOME TAX</b>	14,899	204,754	(660,340)	29,792
<b>INCOME TAX EXPENSE</b>	-	-	-	-
<b>NET INCOME (LOSS)</b>	14,899	204,754	(660,340)	29,792
<b>DIVIDENDS ON PREFERRED STOCK</b>	(6,107)	(6,119)	(18,322)	(18,402)
<b>INCOME (LOSS) APPLICABLE TO COMMON SHARES</b>	<u>\$ 8,792</u>	<u>\$ 198,635</u>	<u>\$ (678,662)</u>	<u>\$ 11,390</u>
<b>EARNINGS PER SHARE - BASIC AND DILUTED</b> (Note 7)				
<b>NET INCOME (LOSS) PER COMMON SHARE BEFORE DIVIDENDS ON PREFERRED STOCK</b>				
Basic	<u>\$ 0.00</u>	<u>\$ 0.06</u>	<u>\$ (0.19)</u>	<u>\$ 0.01</u>
Diluted	<u>\$ 0.00</u>	<u>\$ 0.05</u>	<u>\$ (0.19)</u>	<u>\$ 0.01</u>
<b>INCOME (LOSS) PER COMMON SHARE AFTER DIVIDENDS ON PREFERRED STOCK</b>				
Basic	<u>\$ 0.00</u>	<u>\$ 0.06</u>	<u>\$ (0.19)</u>	<u>\$ 0.00</u>
Diluted	<u>\$ 0.00</u>	<u>\$ 0.05</u>	<u>\$ (0.19)</u>	<u>\$ 0.00</u>
<b>WEIGHTED AVERAGE SHARES OUTSTANDING</b>				
Basic	<u>3,562,259</u>	<u>3,560,196</u>	<u>3,562,186</u>	<u>3,520,490</u>
Diluted	<u>3,896,530</u>	<u>4,086,906</u>	<u>3,562,186</u>	<u>4,122,439</u>

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

SCI ENGINEERED MATERIALS, INC.

STATEMENTS OF CASH FLOWS

NINE MONTHS ENDED SEPTEMBER 30, 2009 AND 2008

(UNAUDITED)

	<u>2009</u>	<u>2008</u>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net (loss) income	\$ (660,340)	\$ 29,792
Adjustments to reconcile net (loss) income to net cash used in operating activities:		
Depreciation and accretion	339,401	281,446
Amortization	2,316	2,316
Stock based compensation	331,117	45,873
Financing expense related to warrant expiration date extension	76,387	-
Gain on sale of equipment	-	(2,000)
Inventory reserve	12,868	7,930
Provision for doubtful accounts	(8,947)	-
Changes in operating assets and liabilities:		
(Increase) decrease in assets:		
Accounts receivable	(128,395)	(397,472)
Inventories	322,855	(764,389)
Prepaid expenses	(385,202)	(149,089)
Other assets	(3,295)	(16,855)
Increase (decrease) in liabilities:		
Accounts payable	163,358	71,007
Accrued expenses and customer deposits	(195,281)	738,670
Total adjustments	<u>527,182</u>	<u>(182,563)</u>
Net cash used in operating activities	<u>(133,158)</u>	<u>(152,771)</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Proceeds on sale of equipment	-	2,000
Purchases of property and equipment	(142,983)	(93,836)
Net cash used in investing activities	<u>(142,983)</u>	<u>(91,836)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Proceeds from exercise of common stock options	1,550	10,250
Proceeds from exercise of common stock warrants	-	68,021
Payments related to registration of common stock	-	(16,906)
Payments related to Preferred Series B dividend	(24,430)	(24,566)
Proceeds from note payable	-	400,000
Principal payments on capital lease obligations and note payable	(272,335)	(467,869)
Net cash used in financing activities	<u>(295,215)</u>	<u>(31,070)</u>

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

**SCI ENGINEERED MATERIALS, INC.**  
**STATEMENTS OF CASH FLOWS (CONTINUED)**  
**NINE MONTHS ENDED SEPTEMBER 30, 2009 AND 2008**  
**(UNAUDITED)**

	<u>2009</u>	<u>2008</u>
<b>NET DECREASE IN CASH</b>	\$ (571,356)	\$ (275,677)
<b>CASH - Beginning of period</b>	1,399,050	1,182,086
<b>CASH - End of period</b>	<u>\$ 827,694</u>	<u>\$ 906,409</u>
<b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION</b>		
Cash paid during the years for:		
Interest, net	\$ 84,057	\$ 79,487
Income taxes	\$ -	\$ -
<b>SUPPLEMENTAL DISCLOSURES OF NONCASH FINANCING ACTIVITIES</b>		
Property and equipment purchased by capital lease	\$ 555,700	\$ 262,900
Machinery & equipment accrued asset retirement obligation increase	\$ 4,968	\$ 2,484
Financing expense related to warrant expiration date extension	\$ 76,387	\$ -
<b>SUPPLEMENTAL DISCLOSURES OF NONCASH OPERATING ACTIVITIES</b>		
Stock based compensation expense	\$ 331,117	\$ 45,873

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

**SCI ENGINEERED MATERIALS, INC.**  
**NOTES TO FINANCIAL STATEMENTS**

**Note 1. Business Organization and Purpose**

SCI Engineered Materials, Inc. (“SCI” or the “Company”), formerly Superconductive Components, Inc., an Ohio corporation, was incorporated in 1987. The Company manufactures ceramic and metal sputtering targets for a variety of industrial applications including: Photonics, Thin Film Solar, Thin Film Battery, Semiconductor, and, to a lesser extent High Temperature Superconductive (HTS) materials. Photonics currently represents the Company’s largest market for its targets. Thin Film Solar is an industry that is exhibiting rapid growth. Thin Film Battery is a developing market where manufacturers of batteries use the Company’s targets to produce very small power supplies with small quantities of stored energy. Semiconductor is a developing market for the Company.

**Note 2. Summary of Significant Accounting Policies**

The accompanying unaudited financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments considered necessary for fair presentation of the results of operations for the periods presented have been included. The financial statements should be read in conjunction with the audited financial statements and the notes thereto for the year ended December 31, 2008. Interim results are not necessarily indicative of results for the full year.

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 at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Equipment purchased with grant funding**

In 2004, the Company received funds of \$517,935 from the Ohio Department of Development’s Third Frontier Action Fund (TFAF) for the purchase of equipment related to the grant’s purpose. In a separate contract with the Department of Energy the Company received \$27,500 for the purchase of equipment related to the contract’s purpose. The Company elected to record the funds disbursed as a contra asset; therefore, the assets are not reflected in the Company’s financial statements. As assets were purchased, the liability initially created when the cash was received was reduced with no revenue recognized or fixed asset recorded on the balance sheet. As of September 30, 2009, the Company had disbursed the entire amount received. The grant and contract both provide that as long as the Company performed in compliance with the grant/contract, the Company retained the rights to the equipment. The grant was completed in January 2009. The Company was in compliance with the requirements and retained the equipment.

**SCI ENGINEERED MATERIALS, INC.**  
**NOTES TO FINANCIAL STATEMENTS**

**Note 2. Summary of Significant Accounting Policies (continued)**

**Stock Based Compensation**

Compensation cost recognized in 2009 and 2008 includes compensation cost for all stock-based awards granted on or subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with the Stock Compensation Topic of the FASB Accounting Standards Codification. Non cash stock based compensation costs were \$331,117 and \$45,873 for the nine months ended September 30, 2009 and 2008, respectively. On January 2, 2009, the Stock Option and Compensation Committee (the "Committee") of the Board of Directors of the Company approved the grant of options to purchase a total of 450,000 shares of the Company's common stock, effective January 2, 2009, to the Company's Chief Executive Officer and three other executive officers. The Committee also approved the grant of options to purchase 90,000 shares to the four non-employee board members. Pursuant to the terms of the agreements, the options have an exercise price of \$6.00 per share, the closing price of the Company's common stock as reported on the OTC Bulletin Board regulated quotation service on January 2, 2009. The four non-employee board members each received compensation of 1,819 shares of the Company's common stock and \$5,000 in 2008.

**Reclassification**

Certain amounts in the prior year financial statements have been reclassified to conform to the current year presentation.

**SCI ENGINEERED MATERIALS, INC.  
NOTES TO FINANCIAL STATEMENTS**

**Note 3. Common Stock and Stock Options**

The cumulative status of options granted and outstanding at September 30, 2009, and December 31, 2008, as well as options which became exercisable in connection with the Stock Option Plans is summarized as follows:

**Employee Stock Options**

	<u>Stock Options</u>	<u>Average Exercise Price</u>
Outstanding at December 31, 2007	343,250	\$ 2.08
Granted	21,000	3.10
Exercised	-	-
Forfeited	(1,500)	3.10
Outstanding at December 31, 2008	362,750	\$ 2.14
Granted	450,000	6.00
Exercised	(1,000)	1.55
Forfeited	(10,000)	3.10
Outstanding at September 30, 2009	<u>801,750</u>	<u>\$ 4.29</u>
Shares exercisable at December 31, 2008	321,050	\$ 2.00
Shares exercisable at September 30, 2009	372,450	\$ 2.51

**Non-Employee Director Stock Options**

	<u>Stock Options</u>	<u>Weighted Average Exercise Price</u>
Outstanding at December 31, 2007	241,000	\$ 2.51
Granted	-	-
Exercised	(7,500)	1.37
Expired	-	-
Forfeited	-	-
Outstanding at December 31, 2008	233,500	\$ 2.54
Granted	90,000	6.00
Exercised	-	-
Expired	-	-
Forfeited	-	-
Outstanding at September 30, 2009	<u>323,500</u>	<u>\$ 3.50</u>
Shares exercisable at December 31, 2008	233,500	\$ 2.54
Shares exercisable at September 30, 2009	263,500	\$ 2.94

**SCI ENGINEERED MATERIALS, INC.**  
**NOTES TO FINANCIAL STATEMENTS**

**Note 3. Common Stock and Stock Options (continued)**

Exercise prices for options range from \$1.00 to \$6.00 at September 30, 2009. The weighted average option price for all options outstanding is \$4.07 with a weighted average remaining contractual life of 6.0 years.

**Note 4. Common Stock Warrants**

On May 1, 2009 the Board of Directors authorized the extension of the expiration date of the common stock purchase warrants that were due to expire in May 2009 and November 2009. The expiration dates were extended to May 2010 and November 2010, respectively. In total, this extension of the expiration date applied to an aggregate of 160,418 warrants. The non-cash financing expense associated with this extension was approximately \$76,000.

**Note 5. Preferred Stock**

On January 15, 2009 the Board of Directors approved the payment of one year of accrued dividends on convertible preferred stock, Series B, to shareholders of record as of December 31, 2008. Payment was disbursed on June 30, 2009.

**Note 6. Inventory**

Inventory is comprised of the following:

	<b>September 30,</b>	<b>December 31,</b>
	<b>2009</b>	<b>2008</b>
	(unaudited)	
Raw materials	\$ 322,755	\$ 299,750
Work-in-progress	415,530	754,097
Finished goods	252,336	259,629
Inventory reserve	(61,910)	(49,043)
	<u>\$ 928,711</u>	<u>\$ 1,264,433</u>

**SCI ENGINEERED MATERIALS, INC.**  
**NOTES TO FINANCIAL STATEMENTS**

**Note 7. Earnings Per Share**

Basic income (loss) per share is calculated as income (loss) available to common stockholders divided by the weighted average of common shares outstanding. Diluted earnings per share is calculated as diluted income available to common stockholders divided by the diluted weighted average number of common shares. Diluted weighted average number of common shares has been calculated using the treasury stock method for Common Stock equivalents, which includes Common Stock issuable pursuant to stock options and Common Stock warrants. For the nine months ended September 30, 2009, all common stock options and warrants are anti-dilutive due to the net loss. The following is provided to reconcile the earnings per share calculations:

	Three months ended Sept 30,		Nine months ended Sept 30,	
	2009	2008	2009	2008
Income (loss) applicable to common shares	\$ 8,792	\$ 198,635	\$ (678,662)	\$ 11,390
Weighted average common shares outstanding – basic	3,562,259	3,560,196	3,562,186	3,520,490
Effect of dilutions	334,271	526,710	-	601,949
Weighted average shares outstanding – diluted	3,896,530	4,086,906	3,562,186	4,122,439

**Note 8. Capital Requirements**

The Company's accumulated deficit since inception was \$8,062,216 (unaudited) at September 30, 2009. While the Company has been profitable in recent years, the historical losses have been financed primarily from additional investments and loans by major shareholders and private offerings of common stock and warrants to purchase common stock. The Company cannot assure that it will continue to operate at a profit or it will be able to raise additional capital in the future to fund its operations.

As of September 30, 2009, cash on-hand was \$827,694. Management believes, based on forecasted sales and expenses, that funding will be adequate to sustain operations at least through September 30, 2010.

Numerous factors may make it necessary for the Company to seek additional capital. In order to support the initiatives included in its business plan, the Company may need to raise additional funds through public or private financing, collaborative relationships or other arrangements. Its ability to raise additional financing depends on many factors beyond its control, including the state of capital markets, the market price of its common stock and the development or prospects for development of competitive products by others. Because the common stock is not listed on a major stock exchange, many investors may not be willing or allowed to purchase it or may demand steep discounts. The additional financing may not be available or may be available only on terms that would result in further dilution to the current owners of the common stock.

**SCI ENGINEERED MATERIALS, INC.**  
**NOTES TO FINANCIAL STATEMENTS**

**Note 9. Note Payable**

On January 22, 2009, the Company issued a Promissory Note dated as of January 13, 2009, to The Huntington National Bank, as Lender, pursuant to a Business Loan Agreement dated as of January 13, 2009. The Note is secured by a Commercial Security Agreement granting the Lender a security interest in the Company's inventory, equipment and accounts. The balance owed on the Note at September 30, 2009 was \$0.

Among other items, the Note provides for the following:

At no time shall the outstanding balance of the principal sum of the Revolving Loan exceed the lesser of (1) \$1,000,000 or (2) an amount equal to the sum of 80% of Eligible Accounts plus the lesser of (A) 50% of Eligible inventory or (B) \$200,000.

Interest on the note is subject to change from time to time based on changes in an independent index which is the LIBO rate. The index at the inception of the note was 0.386% per annum. The interest rate to be applied to the unpaid principal balance during this note will be at a rate of 3.500 percentage points over the index.

All accrued interest is payable monthly. The outstanding principal and accrued interest owed on the Note matures on January 1, 2010.

**Note 10. Concentrations**

At September 30, 2009 the Company had a prepaid expense of approximately \$379,000 to a supplier for the purchase of raw material. The Company is confident the supplier, with revenues of several billion dollars, will continue to deliver the raw material as agreed upon.

**Note 11. Subsequent Event.**

The Securities and Exchange Commission announced on October 2, 2009 that starting for fiscal years on or after June 15, 2010, it will require non-accelerated filers provide an attestation report of their independent auditor on internal control over financial reporting as required by Section 404 of the Sarbanes-Oxley Act of 2002. It was previously announced that non-accelerated filers would be required to provide an attestation report of their independent auditor on internal control beginning for fiscal years ending on or after December 15, 2009. The Company did not anticipate an extension at this late date and incurred expenses of approximately \$42,000 through September 30, 2009 as it prepared to comply with Section 404 of the Act. Under Section 404, public companies and their independent auditors are each required to report on the effectiveness of the companies' internal control over financial reporting.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

The following discussion should be read in conjunction with the Financial Statements and Notes contained herein and with those in our Form 10-K for the year ended December 31, 2008.

Except for the historical information contained herein, the matters discussed in this Quarterly Report on Form 10-Q include certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which are intended to be covered by the safe harbors created thereby. Those statements include, but may not be limited to, all statements regarding our intent, belief, and expectations, such as statements concerning our future profitability and operating and growth strategy. Words such as "believe," "anticipate," "expect," "will," "may," "should," "intend," "plan," "estimate," "predict," "potential," "continue," "likely" and similar expressions are intended to identify forward-looking statements. Investors are cautioned that all forward-looking statements contained in this Quarterly Report on Form 10-Q and in other statements we make involve risks and uncertainties including, without limitation, the factors set forth under the caption "Risk Factors" included in our Annual Report on Form 10-K for the year ended December 31, 2008, and other factors detailed from time to time in our other filings with the Securities and Exchange Commission. One or more of these factors have affected, and in the future could affect our business and financial condition and could cause actual results to differ materially from plans and projections. Although we believe the assumptions underlying the forward-looking statements contained herein are reasonable, there can be no assurance that any of the forward-looking statements included in this Quarterly Report on Form 10-Q will prove to be accurate. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation by us or any other person that our objectives and plans will be achieved.

Any forward-looking statement speaks only as of the date on which such statement is made, and we undertake no obligation to update any forward-looking statement or statements to reflect events or circumstances after the date on which such statements are made or reflect the occurrence of unanticipated events, unless necessary to prevent such statements from becoming misleading. New factors emerge from time to time and it is not possible for us to predict all factors, nor can it assess the impact of each such factor on the business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

**Overview**

SCI Engineered Materials, Inc. ("SCI" or the "Company"), formerly Superconductive Components, Inc., an Ohio corporation, was incorporated in 1987. We manufacture ceramic and metal sputtering targets for a variety of industrial applications including: Photonics, Thin Film Solar, Thin Film Battery, Semiconductor, and, to a lesser extent High Temperature Superconductive (HTS) materials. Photonics currently represents the largest market for our targets. Thin Film Solar is an industry that is exhibiting rapid growth and we expect this market to grow quickly. Thin Film Battery is a developing market where manufacturers of batteries use our targets to produce very small power supplies with small quantities of stored energy. Semiconductor is a developing market for us. We added to our sales staff in late 2007 for the purpose of focusing on opportunities for our products in the Solar industry. We also added staff to our Technology group during the second half of 2007 for the development of innovative products. During the fourth quarter of 2008 we added an exclusive manufacturer's representative for Europe. Late in the second quarter of 2009 we received an order from a Thin Film Solar customer that was more than \$1 million. The entire amount is scheduled to ship during the second half of 2009.

**Executive Summary**

For the nine months ended September 30, 2009, we had \$407,504 in non-cash expenses, which included \$383,296 in non-cash expenses for the following items: stock based compensation for stock options issued in January of 2009 and charges related to the extension of the expiration date of common stock warrants in May of 2009. These non-cash stock based compensation expense included a one time charge of \$175,376 for options that vested immediately and ongoing charges of \$131,533. These ongoing non-cash charges will continue through 2010 and then decline beginning in the first quarter of 2011. The non-cash financing expense related to the extension of the expiration date of common stock warrants was a one time charge of \$76,387. For the nine months ended September 30, 2008, we had \$45,873 in non-cash stock based compensation expense. The increase in these non-cash charges of \$361,631 had a material effect on our Statement of Operations in 2009.

For the nine months ended September 30, 2009, we had revenues of \$5,436,344. This was a decrease of \$1,803,744, or 24.9% when compared to the nine months ended September 30, 2008. Contract research revenue increased to \$697,475 for the first nine months of 2009 from \$89,470 for the same period in 2008, an increase of \$608,005, reflecting the position of our company in key technologies. This increase in contract research revenue combined with revenue from new markets helped offset the decrease in our automotive market revenue. The decline in total revenue can be attributed to the current economic downturn as customers have decreased spending and reduced inventory levels. However, during the third quarter of 2009 some of our automotive customers placed orders with us for delivery during the third and fourth quarters of 2009.

Gross profit was \$1,228,809 for the nine months ended September 30, 2009 compared to \$1,636,438 for the same nine months in 2008. This decrease was due to the lower product revenue mentioned earlier. Gross margin was 22.6% of total revenues for the first nine months of 2009 and 2008.

Given current market conditions, we continued to invest in expanding production capabilities, R&D, marketing and sales. This should allow us to gain market share now and to be poised to receive large orders in targeted applications when this current business downturn recovers.

Benefits from these investments have been trial and qualification orders that were shipped to customers in the Thin Film Solar industry. The revenue from these shipments totaled approximately \$100,000 in the first quarter, \$312,000 in the second quarter, and \$153,000 in the third quarter of 2009, respectively. Some of these trials and qualifications have resulted in orders of approximately \$1.3 million that are scheduled to ship during the second half of 2009. Additionally, late in the second quarter we received some orders from our traditional markets that had been slow during the first six months of 2009. This led to increased revenue in the third quarter of 2009 of \$2,224,756 which was an increase of 69.7% over the second quarter of 2009 and 17.0% better than the first three months of 2009. This could be an indication that restocking inventories or increased business levels is occurring.

For the nine months ended September 30, 2009, we had net loss applicable to common shares of \$678,662 compared to net income of \$11,390 for the same period in 2008. The decrease can be attributed to additional operating expenses of approximately \$185,000 along with the decline in product revenue and gross profit mentioned above. Non-cash stock based compensation expense increased approximately \$285,000 in the first nine months of 2009 versus the first nine months of 2008. A non-cash financing expense related to the extension of the expiration date for warrants was approximately \$76,000 and \$0 for the nine months ended September 30, 2009 and 2008, respectively.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

It is possible that the revenues for the entire year of 2009 could be less than 2008 due to the significant reduction in a high priced raw material. After two years of unusually high prices above the long term average price of this raw material, the price has returned to its long term average. On September 17, 2009 we filed a Form 8-K announcing a major customer informed us that it intended to purchase this high value raw material directly and ship it to us for processing. However, since the September 17, 2009 filing the customer has asked us, at times, to purchase this raw material for them. Should the customer purchase this raw material on a consistent basis and ship it to us for processing it is anticipated that it would not materially impact net income but it would result in lower revenue than previous periods. In addition, the global economic condition has weakened our traditional markets.

All of our employees are committed to fighting through this economic downturn. During the second quarter and the majority of the third quarter of 2009 we reduced hours in most departments and members of management agreed to salary reductions to help reduce costs. Due to the increase in orders and production, all production personnel returned to full time status in September of 2009 and management salary reductions were rescinded in October 2009.

During the third quarter of 2009 we received notification from the Department of Energy of an Assistance Agreement in the amount of approximately \$750,000. This grant provides support for Phase II of a Small Business Innovation Research (SBIR) award entitled "Homogenous BSCCO-2212 Round Wires for Very High Field Magnet Applications." The work on the contract began during the third quarter of 2009 and is expected to continue through August 2011.

In July 2009, the Company was selected by a customer as a subcontractor for an award recently granted by the Ohio Department of Development. This award is entitled "Ohio-Based Manufacturing of Thin-Film Photovoltaics" and provides support for the development of alternate transparent conductive oxides. The work on the contract began during the third quarter of 2009 and is projected to be completed during 2010. The amount of the subcontract work to be performed by the Company is \$125,000.

We received notification during the fourth quarter of 2008 from the Ohio Department of Development's Third Frontier Advanced Energy Program (TFAEP) of an award in the amount of \$708,715. This grant provides support to commercialize technologies for the manufacture of rotatable ceramic sputtering targets for the production of transparent conductive oxide-coated glass used in manufacturing thin film photovoltaic solar cell panels. The work on the contract began in January of 2009 and is expected to continue through January 2011..

During the third quarter of 2008 we received notification from the Department of Energy of a Notice of Financial Assistance Award in the amount of approximately \$750,000. The initial \$125,000 was formally approved during 2008. The remaining balance was approved in February 2009. This grant provides support for Phase II of a Small Business Innovation Research (SBIR) award entitled "Flux Pinning Additions to Increase Jc Performance in BSCCO-2212 Round Wire for Very High Field Magnets." The work on the contract began during the third quarter of 2008 and is expected to continue through August 2010.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

We received notification during the second quarter of 2008 from the Department of Energy of a Notice of Financial Assistance Award in the amount of \$99,961. This award provided support for Phase I of an SBIR award entitled "Homogenous BSCCO-2212 Round Wires for Very High Field Magnet Applications." The work on the contract began during the third quarter of 2008 and was completed during the first quarter of 2009.

**RESULTS OF OPERATIONS**

**Nine and three months ended September 30, 2009 (unaudited) compared to nine and three months ended September 30, 2008 (unaudited):**

**Revenues**

For the nine months ended September 30, 2009, we had revenues of \$5,436,344. This was a decrease of \$1,803,744, or 24.9%, compared to the nine months ended September 30, 2008. Contract research revenue increased to \$697,475 for the first nine months of 2009 from \$89,470 for the same period in 2008, an increase of \$608,005, reflecting our position in key technologies. This increase in contract research revenue combined with revenue from new markets helped offset the decrease in our automotive market revenue. The decline in total revenue can be attributed to the current economic downturn as customers have decreased spending and reduced inventory levels.

For the three months ended September 30, 2009 we had revenues of \$2,224,756 compared to \$4,008,635 for the same period in 2008. Contract research revenue was \$196,401 for the three months ended September 30, 2009 versus \$49,349 for the three months ended September 30, 2008. Product revenue was \$2,028,355 for the third quarter of 2009 compared to \$3,959,286 for the third quarter of 2008, a decrease of \$1,930,931. This decrease can be attributable to the automotive market. As mentioned above, this decline in product revenue can also be attributed to the current economic downturn as customers have decreased spending and reduced inventory levels.

Late in the second quarter of 2009, we received a \$1 million order from a solar customer and commenced shipping against this order in the third quarter. In addition we began receiving orders from our traditional markets. This led to revenue in the third quarter of 2009 of \$2,224,756, which was an increase of 69.7% over the second quarter of 2009 and 17.0% better than the first three months of 2009. This could be an indication of a need to restock inventories or an increase in business levels.

**Gross Profit**

Gross profit for the nine months ended September 30, 2009 was \$1,228,809 which represented a gross margin of 22.6% of total revenue compared to \$1,636,438 and 22.6% of total revenue for the nine months ended September 30, 2008. Gross profit for the three months ended September 30, 2009 was \$552,299 which represented a gross margin of 24.8% of total revenue compared to \$769,566 and 19.2% of total revenue for the three months ended September 30, 2008. The gross profit decline can be attributed primarily to the decrease in product revenue previously mentioned.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

**Marketing and Sales Expense**

Marketing and Sales expense for the nine months ended September 30, 2009 increased 11.6% to \$492,557 from \$441,556 for the same period in 2008. The increase was due to increased non-cash stock based compensation expense of approximately \$38,000, higher expenses related to trade shows of approximately \$12,000 as well as increased commissions to our outside manufacturing sales representatives of approximately \$33,000. A portion of this increase was offset by a reduction in compensation to our inside personnel of approximately \$30,000. Marketing and Sales expense for the three months ended September 30, 2009 increased 5.1% to \$178,107 from \$169,524 for the same period in 2008.

We anticipate increased trade show expenses in 2010 as we continue to expand our marketing efforts into foreign markets.

**General and Administrative Expense**

General and administrative expense for the nine months ended September 30, 2009 increased to \$977,430 from \$751,562 for the nine months ended September 30, 2008, or 30.1%. The increase was primarily the result of non-cash stock based compensation expense of approximately \$243,000 compared to approximately \$36,000 for the same period in 2008, as well as expenses related to Sarbanes Oxley which were approximately \$42,000 for the nine months ended September 30, 2009 versus approximately \$5,000 for the same period in 2008. General and administrative expense for the three months ended September 30, 2009 increased to \$273,472 from \$241,101 for the three months ended September 30, 2008, or 13.4%. The increase was primarily the result of expenses related to Sarbanes Oxley which were \$37,580 for the three months ended September 30, 2009 versus \$227 for the same period in 2008, an increase of \$37,353. A portion of this increase was offset by a reduction in compensation.

**Research and Development Expense**

Research and development expense for the first nine months of 2009 was \$264,406 compared to \$355,785 for the same period in 2008, a decrease of 25.7%. Research and development expense for the three months ended September 30, 2009 was \$59,829 compared to \$133,066 for the same period in 2008, a decrease of 55.0%. We continue to incur expenses associated with the continued development efforts in the Photonic, Thin Film Solar, Thin Film Battery and Semiconductor markets, as well as research related to the SBIRs and TFAEP. The decrease in expense was a result of compensation that was assigned to Cost of Contract Research Revenue of approximately \$59,000 for the third quarter of 2009 and \$162,000 for the nine months ended September 30, 2009.

**Other Income and Expense**

Interest income was \$5,688 and \$19,744 for the nine months ended September 30, 2009 and 2008, respectively. Interest income was \$842 and \$5,569 for the three months ended September 30, 2009 and 2008, respectively. The decrease in interest rates reduced the amount of interest earned.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

Interest expense was \$84,057 and \$79,487 for the nine months ended September 30, 2009 and 2008, respectively and \$26,834 and \$27,490 for the three months ended September 30, 2009 and 2008, respectively. The increase was due to additional capital lease obligations incurred for the purchase of production equipment for increased production capacity. We received loan proceeds in the amount of \$400,000 from the Ohio Department of Development in 2008. These proceeds were used to reduce the balance on outstanding capital lease obligations. The favorable interest rate on this loan (3%) helped offset the interest expense related to new capital lease obligations.

The non-cash financing expense associated with the extension of the warrant expiration date previously mentioned was approximately \$76,000 for the nine months ended September 30, 2009 versus \$0 in 2008.

**INCOME (LOSS) APPLICABLE TO COMMON SHARES**

Loss applicable to common shares was \$678,662, or \$(0.19) per common share compared to net income of \$11,390, or \$0.00 per common share for the nine months ended September 30, 2009 and 2008, respectively. The loss or income applicable to common shares includes net loss or net income from operations and the accretion of Series B preferred stock dividends. Dividends on the Series B preferred stock accrue at 10% annually on the outstanding shares. Accrued dividends on the Series B preferred stock was \$18,322 and \$18,402 for the nine months ended September 30, 2009 and 2008, respectively. Basic net loss per common share before dividends on preferred stock and based on (loss) income applicable to common shares was \$(0.19) and \$0.01 for the nine months ended September 30, 2009 and 2008, respectively.

The weighted averaged shares outstanding were 3,562,186 at September 30, 2009. All outstanding common stock equivalents were anti-dilutive for the nine months ended September 30, 2009 due to the net loss. Basic and diluted net income for the nine months ended September 30, 2008 was \$0.00 per common share based on 3,520,490 and 4,122,439 weighted average shares outstanding, respectively.

Basic net income applicable to common shares for the three months ended September 30, 2009 was \$0.00 per common share based on 3,562,259 weighted average shares outstanding compared to \$0.06 per common share based on 3,560,196 weighted average shares outstanding for the three months ended September 30, 2008.

Diluted net income applicable to common shares for the three months ended September 30, 2009 was \$0.00 per common share based on 3,896,530 weighted average shares outstanding compared to \$0.05 per common share based on 4,086,906 weighted average shares outstanding for the three months ended September 30, 2008.

The income applicable to common shares includes net income from operations and the accretion of Series B preferred stock dividends. Dividends on the Series B preferred stock accrue at 10% annually on the outstanding shares. Accrued dividends on the Series B preferred stock was \$6,107 and \$6,119 for the three months ended September 30, 2009 and 2008, respectively.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

The following schedule represents our outstanding common shares during the period of 2009 through 2019 assuming all outstanding stock options and stock warrants are exercised during the year of expiration. If each shareholder exercises his or her options or warrants, it could increase our common shares by 1,682,307 to 5,244,566 by December 31, 2019. Exercise prices for options and warrants range from \$1.00 to \$6.00 at September 30, 2009. Assuming all such options and warrants are exercised in the year of expiration, the effect on shares outstanding is illustrated as follows:

	<u>Options and Warrants due to expire</u>	<u>Potential Shares Outstanding</u>
2009	-	3,562,259
2010	603,807	4,166,066
2011	62,500	4,228,566
2012	169,000	4,397,566
2013	30,500	4,428,066
2014	180,000	4,608,066
2015	140,000	4,748,066
2016	37,000	4,785,066
2017	-	4,785,066
2018	9,500	4,794,566
2019	450,000	5,244,566

**LIQUIDITY AND WORKING CAPITAL**

At September 30, 2009, working capital was \$1,303,033 compared to \$1,742,912 at September 30, 2008. We used cash in operations of approximately \$133,000 for the nine months ended September 30, 2009 and approximately \$153,000 for the nine months ended September 30, 2008. Significant non-cash items including depreciation, accretion and amortization, stock based compensation expense, financing expense of warrant extension, inventory reserve on excess and obsolete inventory, and provision for doubtful accounts were approximately \$753,000 and \$338,000 respectively, for the nine months ended September 30, 2009 and 2008. Accounts receivable, inventory, prepaid expenses and other assets increased approximately \$194,000 for the nine months ended September 30, 2009. Accounts receivable, inventory, prepaid expenses and other assets increased approximately \$1,327,800 for the nine months ended September 30, 2008. Accounts payable, accrued expenses and customer deposits decreased approximately \$32,000 for the nine months ended September 30, 2009 and increased approximately \$810,000 for the same period in 2008. Cash of approximately \$143,000 and \$92,000 was used for investing activities for the nine months ended September 30, 2009 and 2008, respectively. The amounts invested were used to purchase machinery and equipment for increased production capacity and new product lines.

Cash of approximately \$295,000 was used for financing activities during the nine months ended September 30, 2009. Cash payments to third parties for capital lease obligations and a note payable approximated \$272,000. Proceeds received from the exercise of common stock options were \$1,550. Payments related to Series B Preferred stock dividends were \$24,430. We incurred new capital lease obligations of approximately \$556,000 for new production equipment.

Cash of approximately \$31,000 was used for financing activities during the nine months ended September 30, 2008. Cash payments to third parties for capital lease obligations approximated \$468,000. Proceeds received from a note payable were \$400,000. Proceeds received from the exercise of common stock warrants were approximately \$68,000. Proceeds received from the exercise of common stock options were \$10,250. Payments related to Series B Preferred stock dividends were \$24,566. Payments related to the registration of common stock were approximately \$17,000. We incurred new capital lease obligations of approximately \$263,000 for new production equipment.

## **RISK FACTORS**

We desire to take advantage of the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. The following factors, as well as the factors listed under the caption "Risk Factors" in our Form 10-K filed with the Securities and Exchange Commission on February 26, 2009, have affected or could affect our actual results and could cause such results to differ materially from those expressed in any forward-looking statements made by us. Investors should consider carefully these risks and speculative factors inherent in and affecting our business and an investment in our common stock.

### **Historically we have experienced significant operating losses and may continue to do so in the future.**

While we have had profitable operations in recent years, profits have not been consistent and we financed the historical losses primarily from additional investments and loans by our major shareholders and private offerings of common stock and warrants to purchase common stock. We cannot assure you that we will be able to raise additional capital in the future to fund our operations. While certain of our major shareholders have advanced funds in the form of secured debt, subordinated debt, accounts payable and guaranteeing bank debt in the past, there is no commitment by these individuals to continue funding us or guaranteeing bank debt in the future. We will continue to seek new financing or equity financing arrangements. However, we cannot be certain that we will be successful in efforts to raise additional funds.

### **Off Balance Sheet Arrangements**

We have no off balance sheet arrangements including special purpose entities.

### **Critical Accounting Policies**

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires management to make judgments, assumptions and estimates that affect the amounts reported in the Financial Statements and accompanying notes. Note 2 to the Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2008 describes the significant accounting policies and methods used in the preparation of the Financial Statements. Estimates are used for, but not limited to, accounting for the allowance for doubtful accounts, inventory allowances, property and equipment depreciable lives, patents and licenses useful lives, and assessing changes in which impairment of certain long-lived assets may occur. Actual results could differ from these estimates. The following critical accounting policies are impacted significantly by judgments, assumptions and estimates used in the preparation of the Financial Statements. The allowance for doubtful accounts is based on our assessment of the collectability of specific customer accounts and the aging of the accounts receivable. If there is a deterioration of a major customer's credit worthiness or actual defaults are higher than our historical experience, our estimates of the recoverability of amounts due us could be adversely affected. Inventory purchases and commitments are based upon future demand forecasts. If there is a sudden and significant decrease in demand for our products or there is a higher risk of inventory obsolescence because of rapidly changing technology and customer requirements, we may be required to increase our inventory allowances and our gross margin could be adversely affected.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**

Depreciable and useful lives estimated for property and equipment, licenses and patents are based on initial expectations of the period of time these assets and intangibles will benefit us. Changes in circumstances related to a change in our business, change in technology or other factors could result in these assets becoming impaired, which could adversely affect the value of these assets.

**Item 4. Controls and Procedures**

**Evaluation of Disclosure Controls and Procedures**

Based on an evaluation under the supervision and with the participation of our management, our principal executive officer and principal financial officer have concluded that the our disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended ("Exchange Act") were effective as of September 30, 2009 to ensure that information required to be disclosed in reports that are filed or submitted under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms and (ii) accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

**Inherent Limitations over Internal Controls**

Our internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Our internal control over financial reporting includes those policies and procedures that: (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures are being made only in accordance with authorizations of management and directors; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of assets that could have a material effect on the financial statements.

Management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our internal controls will prevent or detect all errors and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of internal controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected. Also, any evaluation of the effectiveness of controls in future periods is subject to the risk that those internal controls may become inadequate because of changes in business conditions or that the degree of compliance with the policies or procedures may deteriorate.

Additionally, there were no changes in our internal controls that could materially affect our disclosure controls and procedures subsequent to the date of their evaluation, nor were there any material deficiencies or material weaknesses in our internal controls. As a result, no corrective actions were required.

## Part II. Other Information

### Item 6. Exhibits.

- 10.1 Description of information received from a customer regarding customer's intent to purchase material directly and ship it to the Company (Incorporated by reference to the Company's Current Report on Form 8-K, dated September 17, 2009).
- 31.1 Rule 13a-14(a) Certification of Principal Executive Officer.\*
- 31.2 Rule 13a-14(a) Certification of Principal Financial Officer.\*
- 32.1 Section 1350 Certification of Principal Executive Officer.\*
- 32.2 Section 1350 Certification of Principal Financial Officer and Principal Accounting Officer.\*
- 99.1 Press Release dated November 3, 2009, entitled "SCI Engineered Materials, Inc. Reports Third Quarter 2009 Results."

\* Filed with this report

### Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

#### SCI ENGINEERED MATERIALS, INC.

Date: November 3, 2009

/s/ Daniel Rooney

Daniel Rooney, Chairman of the Board of  
Directors, President and Chief Executive Officer  
(Principal Executive Officer)

/s/ Gerald S. Blaskie

Gerald S. Blaskie, Vice President and Chief  
Financial Officer  
(Principal Financial Officer and Principal  
Accounting Officer)