

PHOTONIC PRODUCTS GROUP INC
Form 10-Q
November 14, 2006

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, 2006

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 0-11668

PHOTONIC PRODUCTS GROUP, INC.

(Exact name of registrant as specified in its charter)

New Jersey
(State or other jurisdiction of incorporation
or organization)

22-2003247
(I.R.S. Employer
Identification Number)

181 Legrand Avenue, Northvale, NJ 07647
(Address of principal executive offices)
(Zip Code)

(201) 767-1910
(Registrant's telephone number, including area code)

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(Former name, former address and formal 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, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange act).

Yes No

Common shares of stock outstanding as of November 6, 2006:

7,847,474 shares

Photonic Products Group, Inc. and Subsidiaries

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PHOTONIC PRODUCTS GROUP, INC AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	September 30, 2006 (Unaudited)	December 31, 2005 (Audited)
Assets		
Current assets:		
Cash and cash equivalents	\$ 1,651,449	\$ 1,156,563
Accounts receivable (net of allowance for doubtful accounts of \$15,000 in 2006 and 2005)	1,697,500	2,265,934
Inventories	2,456,606	2,423,879
Other current assets	512,794	153,723
Total Current Assets	6,318,349	6,000,099
Plant and equipment,		
Plant and equipment at cost	13,439,350	12,472,480
Less: Accumulated depreciation and amortization	(8,888,085)	(8,143,592)
Total plant and equipment	4,551,265	4,328,888
Precious Metals	130,732	130,732
Intangible Assets	2,797,995	2,856,918
Other Assets	137,960	164,384
Total Assets	\$ 13,936,301	\$ 13,481,021
Liabilities and Shareholders' Equity		
Current Liabilities:		
Current portion of notes payable - other	\$ 181,396	\$ 260,697
Accounts payable and accrued liabilities	2,065,615	2,426,692
Customer advances	380,312	652,264
Current obligations under capital leases	220,524	248,550
Total current liabilities	2,847,847	3,588,203
Secured and Convertible Notes Payable	5,200,000	5,200,000
Notes Payable, other, net of current portion	1,088,036	518,786
Capital Lease Obligations	84,028	244,625
Total Liabilities	9,219,911	9,551,614
Shareholders' equity:		
10% convertible preferred stock, Series A no par value; 500 shares issued and outstanding respectively	500,000	500,000
10% convertible preferred stock, Series B no par value; 2,082 shares issued and outstanding at September 30, 2006 and 2,100 shares issued and outstanding at December 31, 2005	2,082,000	2,100,000
Common stock: \$.01 par value; 60,000,000 authorized 7,772,074 shares issued at September 30, 2006 and 7,287,398 issued December 31, 2005	77,720	72,862
Capital in excess of par value	11,798,376	11,145,243
Accumulated deficit	(9,726,756)	(9,873,748)
	4,731,340	3,944,357
Less: Common stock in treasury, at cost (4,600 shares respectively)	(14,950)	(14,950)
Total Shareholders' Equity	4,716,390	3,929,407
Total Liabilities and Shareholders' Equity	\$ 13,936,301	\$ 13,481,021

See Notes to Consolidated Financial Statements

PHOTONIC PRODUCTS GROUP, INC AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Total Revenue	\$ 3,049,333	3,581,339	\$ 10,243,529	\$ 9,906,048
Cost and Expenses:				
Cost of goods sold	2,166,397	2,475,572	7,051,762	7,449,106
Selling, general & administrative expenses	907,207	788,195	2,763,279	2,545,159
Internal R & D expenses		38,869		41,124
Total Cost and Expenses	3,073,604	3,302,636	9,815,041	10,035,389
Operating income (loss) from operations	(24,271)	278,703	428,488	(129,341)
Other income (expense):				
Interest expense net	(102,175)	(107,885)	(332,945)	(359,757)
Settlement of insurance claim	300,000		300,000	
Gain on sale of precious metals		135,931		135,931
Other	(553)	775	(14,051)	3,853
Net income (loss)	173,001	307,524	381,492	(349,314)
Preferred stock dividends			(234,500)	(134,000)
Net income (loss) applicable to common shareholders	\$ 173,001	\$ 307,524	\$ 146,992	\$ (483,314)
Net income (loss) per common share basic	\$ 0.02	\$ 0.04	\$ 0.02	\$ (0.07)
Net income (loss) per common share diluted	\$ 0.02	\$ 0.03	\$ 0.02	\$ (0.07)
Weighted average shares outstanding basic	7,772,074	7,421,694	7,476,924	7,238,147
Weighted average shares outstanding diluted	13,431,343	12,240,365	8,428,941	7,238,147

See Notes to Consolidated Financial Statements

PHOTONIC PRODUCTS GROUP, INC AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Nine Months Ended September 30,	
	2006	2005
Cash flows from operating activities:		
Net income (loss)	\$ 381,492	\$ (349,314)
Adjustments to reconcile net income (loss) to cash provided by (used in) operating activities:		
Depreciation and amortization	803,416	708,762
401K common stock contribution	150,501	51,482
Stock based compensation	62,348	
Gain on sale of precious metals		(135,931)
Changes in assets and liabilities:		
Accounts receivable	568,434	(483,657)
Inventories	(32,727)	211,738
Other current assets	(359,071)	(68,098)
Other assets	26,424	14,767
Accounts payable and accrued liabilities	(266,265)	(216,275)
Customer advances	(271,952)	(380,127)
Total adjustments	681,108	(297,339)
Net cash provided by (used in) operating activities	1,062,600	(646,653)
Cash flows from investing activities:		
Capital expenditures	(966,870)	(190,905)
Proceeds from sale of precious metals		314,824
Net cash provided by (used in) investing activities	(966,870)	123,919
Cash flows from financing activities:		
Proceeds from issuance of common stock	97,830	
Proceeds from promissory note	700,000	
Principal payments of notes payable	(210,051)	(116,339)
Principal payments of capital lease obligations	(188,623)	(245,341)
Net cash provided by (used in) financing activities	399,156	(361,680)
Net increase (decrease) in cash and cash equivalents	494,886	(884,414)
Cash and cash equivalents at beginning of period	1,156,563	1,393,507
Cash and cash equivalents at end of period	\$ 1,651,449	\$ 509,093

See Notes to Consolidated Financial Statements

Photonic Products Group, Inc.**Notes to Consolidated Financial Statements****(Unaudited)****NOTE 1 –SUMMARY OF ACCOUNTING POLICIES****Basis of Presentation**

The accompanying unaudited interim consolidated financial statements of Photonic Products Group, Inc. (the Company) reflect all adjustments, which are of a normal recurring nature, and disclosures which, in the opinion of management, are necessary for a fair statement of results for the interim periods. It is suggested that these consolidated financial statements be read in conjunction with the audited consolidated financial statements as of December 31, 2005 and 2004 and for the years then ended and notes thereto included in the Company's report on Form 10-K and Amendment No. 1 on Form 10-K/A, filed with the Securities and Exchange Commission.

Inventory Valuation

Inventories are valued on a lower of cost (first-in-first-out basis) or market basis (net realizable value). Work in process inventory for the period is stated at actual cost, not in excess of estimated realizable value.

Inventories are comprised of the following:

	September 30, 2006	December 31, 2005
Raw materials	\$ 752,000	\$ 616,000
Work in process, including manufactured parts and components	1,158,000	1,350,000
Finished goods	547,000	458,000
	\$ 2,457,000	\$ 2,424,000

Income Taxes

The Company recognizes deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in the Company's financial statements or tax returns. Deferred tax assets and liabilities are determined based on the difference between the financial statement carrying amounts and the tax bases of assets and liabilities using enacted tax rates in effect in the years in which the differences are expected to reverse.

Net Income Per Share

Basic and diluted net income (loss) per share is computed using the weighted average number of common shares outstanding. Diluted net income per share also includes the weighted average of common share equivalents including options, warrants, convertible debt and convertible preferred stock. For the nine month period ended September 30, 2005 the potential dilutive effect of securities, which are common share equivalents, options, warrants, convertible notes and convertible preferred stock and their associated dividends has been excluded from the diluted computation because their effect is anti-dilutive.

The following is the reconciliation of the basic and diluted earnings per share computations required by Statement of Financial Standards (SFAS) No. 128 (Earnings per Share)

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	Three Months Ended September 30, 2006			Three Months Ended September 30, 2005		
	Income (Numerator)	Shares (Denominator)	Per Share Amount	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic Earnings Per Share:						
Net Income Applicable to Common Shareholders	\$ 173,001	7,772,074	\$ 0.02	\$ 307,524	7,421,694	\$ 0.04
Effect of dilutive securities						
Convertible Debt	52,500	3,500,000		52,500	3,500,000	
Convertible Preferred Stock		1,332,800			840,000	
Options and Warrants		826,470			478,671	
Diluted Earnings Per Share:						
Net Income Applicable to Common Shareholders	\$ 225,501	13,431,343	\$ 0.02	\$ 360,024	12,240,365	\$ 0.03

	Nine Months Ended September 30, 2006			Nine Months Ended September 30, 2005		
	Income (Numerator)	Shares (Denominator)	Per-Share Amount	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic Earnings Per Share:						
Net Income (Loss) Applicable to Common Shareholders	\$ 146,992	7,476,924	\$ 0.02	\$ (483,314)	7,238,147	\$ (0.07)
Effect of dilutive securities						
Convertible debt Options and Warrants		952,018				
Diluted Earnings Per Share:						
Net Income (Loss) Applicable to Common Shareholders	\$ 146,992	8,428,941	\$ 0.02	\$ (483,314)	7,238,147	\$ (0.07)

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Stock Based Compensation

The Company's 2000 Equity Compensation Program, which is shareholder approved, permits the grant of share options to its employees for up to 400,000 shares of common stock as stock compensation per calendar year. All stock options under the Plan are granted at the fair market value of the common stock at the grant date. Employee stock options vest ratably over a three year period and expire 10 years from the grant date.

Effective January 1, 2006, the Company's Plan is accounted for in accordance with the recognition and measurement provisions of Statement of Financial Accounting Standards

(FAS) No. 123 (revised 2004), Share-Based Payment (FAS 123(R)), which replaces FAS No. 123, Accounting for Stock-Based Compensation, and supersedes Accounting Principles Board Opinion (APB) No. 25, Accounting for Stock Issued to Employees, and related interpretations. FAS 123 (R) requires compensation costs related to share-based payment transactions, including employee stock options, to be recognized in the financial statements. In addition, the Company adheres to the guidance set forth within Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 107, which provides the Staff's views regarding the interaction between SFAS No. 123(R) and certain SEC rules and regulations and provides interpretations with respect to the valuation of share-based payments for public companies.

Prior to January 1, 2006, the Company accounted for similar transactions in accordance with APB No. 25 which employed the intrinsic value method of measuring compensation cost. Accordingly, compensation expense was not recognized for fixed stock options if the exercise price of the option equaled or exceeded the fair value of the underlying stock at the grant date.

While FAS No. 123 encouraged recognition of the fair value of all stock-based awards on the date of grant as expense over the vesting period, companies were permitted to continue to apply the intrinsic value-based method of accounting prescribed by APB No. 25 and disclose certain pro-forma amounts as if the fair value approach of SFAS No. 123 had been applied. In December 2002, FAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure, an amendment of SFAS No. 123, was issued, which, in addition to providing alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation, required more prominent pro-forma disclosures in both the annual and interim financial statements. The Company complied with these disclosure requirements for all applicable periods prior to January 1, 2006.

In adopting FAS 123(R), the Company applied the modified prospective approach to transition. Under the modified prospective approach, the provisions of FAS 123 (R) are to be applied to new awards and to awards modified, repurchased, or cancelled after the required effective date. Additionally, compensation cost for the portion of awards for which the requisite service has not been rendered that are outstanding as of the required effective date shall be recognized as the requisite service is rendered on or after the required effective date. The compensation cost for that portion of awards shall be based on the grant-date fair value of those awards as calculated for either recognition or pro-forma disclosures under FAS 123.

As a result of the adoption of FAS 123 (R), the Company's results for the three month period ended September 30, 2006 include share-based compensation expense totaling \$19,697. Such amounts have been included in the Consolidated Statements of Operations within cost of goods sold (\$3,955), and selling, general and administrative expenses (\$15,742), as appropriate. For nine months ended September 30, 2006, share-based compensation expense was \$62,348 including \$11,861 within cost of goods sold and \$50,487 within selling, general and administrative expense, as appropriate. No income tax benefit has been recognized in the income statement for share-based compensation arrangements due to history of operating losses. Stock compensation expense recorded under APB No. 25 in the Consolidated Statements of Operations for the three months and nine months ended September 30, 2005 totaled \$-0-.

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Stock option compensation expense in 2006 is the estimated fair value of options granted amortized on a straight-line basis over the requisite service period.

The weighted average estimated fair value of stock options granted in the nine months ended September 30, 2006 and 2005 was \$1.46 and \$1.02, respectively. The fair value of options at the date of grant was estimated using the Black-Scholes option pricing model. During 2006, the Company took into consideration guidance under SFAS 123R and SEC Staff Accounting Bulletin No. 107 (SAB 107) when reviewing and updating assumptions. The expected volatility is based upon historical volatility of our stock and other contributing factors. The expected term is based upon the contractual term of the option.

The assumptions made in calculating the fair values of options are as follows:

	Nine Months Ended September 30, 2006		September 30, 2005	
Expected term (in years)	10		10	
Expected volatility	121.11	%	168.96	%
Expected dividend yield	0	%	0	%
Risk-free interest rate	5.2	%	5.2	%

The following table addresses the additional disclosure requirements of 123(R) in the period of adoption. The table illustrates the effect on net income and earnings per share as if the fair value recognition provisions of FAS No. 123 had been applied to all outstanding and unvested awards in the prior year comparable period.

	For the three months ended September 30, 2005	For the nine months ended September 30, 2005
Net income (loss) attributable to common stockholders, as reported	\$ 307,524	\$ (483,314)