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)

x **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

o **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	**22-2003247**
(State or other jurisdiction of incorporation or organization)	(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)

(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 x No o

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 o Accelerated filer o Non-accelerated filer x

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

Yes o No x

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

7,847,474 shares

Photonic Products Group, Inc. and Subsidiaries

INDEX

Part I. FINANCIAL INFORMATION

Item 1.	Financial Statements:
	Consolidated Balance Sheets as of September 30, 2006, (unaudited) and December 31, 2005 (audited)
	Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2006 and 2005 (unaudited)
	Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2006 and 2005 (unaudited)
	Notes to Consolidated Financial Statements (unaudited)
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations
Item 3.	Quantitative and Qualitative Disclosures About Market Risk
Item 4.	Controls and Procedures

Part II. OTHER INFORMATION

Item 1.	Legal Proceedings
Item 1A.	Risk Factors
Item 3.	Unregistered Sales of Equity Securities and Use of Proceeds
Item 4.	Submission of Matters to a Vote of Security Holders
Item 5.	Other Information
Item 6.	Exhibits

Signatures

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

3

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

	Three Months Ended September 30, 2006	2005	Nine Months Ended September 30, 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

4

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)

	Three Months Ended September 30, 2006 Income (Numerator)	**Shares (Denominator)**	**Per Share Amount**	**Three Months Ended September 30, 2005 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 Income (Numerator)	**Shares (Denominator)**	**Per-Share Amount**	**Nine Months Ended September 30, 2005 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)

7

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-.

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	)
Add: Stock-based compensation included in reported net loss	0			0		
Deduct: Total stock based compensation expense determined under the fair value based method for all awards (no tax effect)	(45,277		)	(135,831		)
Pro forma net income (loss) attributable to common stockholders	$	262,247		$	(619,145	)
Net income (loss) per share:						
Basic income (loss) per share - as reported	$	.04		$	(.07	)
Basic income (loss) per share - pro forma	$	.04		$	(.08	)
Diluted income (loss) per share - as reported	$	.03		$	(.07	)
Diluted income (loss) per share - pro forma	$	.02		$	(.08	)

The Company granted -0- options under the Plan during the three months ended September 30, 2006. In the three months ended September 30, 2005, 4,500 options were granted at an exercise price of $0.99 per share.

The following table represents our stock options granted, exercised, and forfeited during the first nine months of 2006.

Stock Options	Number of Options	Weighted Average Exercise Price per Option	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at January 1, 2006	2,194,800	$1.18		
Granted	77,200	$1.53		
Exercised	(115,000)	$0.85		
Forfeited/expired	(222,300)	$1.14		
Outstanding at September 30, 2006	1,934,700	$1.33	4.43	$0.00
Exercisable at September 30, 2006	1,789,180	$1.35	4.22	$0.00

The following table represents non-vested stock options granted, vested, and forfeited during the nine months ended September 30 2006.

Non-vested Options	Options	Weighted-Average Grant-Date Fair Value
Non-vested January 1, 2006	263,466	$ 0.69
Granted	77,200	$ 1.46
Vested	(132,846)	$ 0.50
Forfeited	(62,300)	$ 1.08
Non-vested September 30, 2006	145,520	$ 1.01

As of September 30, 2006, there was $103,000 of unrecognized compensation cost, net of estimated forfeitures, related to non-vested stock options, which is expected to be recognized over a weighted average period of approximately 2.3 years. The total fair value of shares vested during the nine months ended September 30, 2006 and 2005, was $63,766 and $137,000, respectively.

10

NOTE 2. IMPACT OF UNAUTHORIZED PERSONAL TRANSACTIONS BY FORMER CFO

As discussed in the Explanatory Note and in Item 9a Controls and Procedures, in the Company s Amendment No. 1 on Form 10-K/A filed with the Securities and Exchange Commission on September 29, 2006, the results of an investigation by our Audit Committee through an independent forensic accounting specialist revealed that over a period of approximately six years, from the second quarter of 2000 through the second quarter of 2006, the Company s former Chief Financial Officer, William Miraglia, had engaged in unauthorized and personal transactions totaling $860,000. This included unauthorized charges on the Company s debit card of approximately $711,000. In addition, the investigation discovered that Mr. Miraglia made payments totaling $94,500, by check to the IRS with respect to a personal tax levy against him over a period of approximately two years (third quarter 2004 through second quarter 2006), in addition to, other unapproved payments and misappropriation of funds totaling approximately $36,000. As a result of the foregoing discoveries, Mr. Miraglia was terminated for cause from his employment with the Company on June 14, 2006.

11

A summary of unauthorized personal transactions which occurred from approximately the second quarter of 2000 through the second quarter of 2006, follows:

	QUARTER ENDED March 31	June 30	September 30	December 31	TOTAL
From the second quarter 2000 to December 31, 2000	$ n/a	$ 1,000	$ 24,000	$ 25,000	$ 50,000
From January 1, 2001 to December 31, 2001	31,000	50,000	17,000	15,000	113,000
From January 1, 2002 to December 31, 2002	21,000	21,000	8,000	16,000	66,000
From January 1, 2003 to December 31, 2003	15,000	32,000	54,000	29,000	130,000
From January 1, 2004 to December 31, 2004	44,000	43,000	67,000	81,000	235,000
From January 1, 2005 to December 31, 2005	39,000	63,000	52,000	55,000	209,000
Total through December 31, 2005					$ 803,000
From January 1, 2006 to June 30, 2006	47,000	10,000	n/a	n/a	57,000
Total Unauthorized Personal Transactions					$ 860,000

Mr. Miraglia recorded these transactions primarily through journal entries prepared and entered by himself into the Company s accounts. The transactions were reflected as Selling, General and Administrative expenses. Although the transactions were unauthorized and personal in nature, based upon a review of the accounting treatment of individual transactions, the Company has concluded that all material charges have been reflected as part of the reported expenses, reported net income, earnings per share and cash flows in the appropriate periods.

The Company filed a claim to recover a portion of these losses under its employee dishonesty insurance policy, to the extent permitted as a result of policy limits on time and amounts of coverage. On September 29, 2006, the claim was settled in the amount of $300,000, the policy limit, and the proceeds were deposited in the Company s bank account on October 2, 2006. In addition, Mr. Miraglia has signed an agreement to make restitution to the Company. To date, he has repaid $5,000. In light of a number of factors, the Company does not believe that any significant further recoveries from Mr. Miraglia are likely in the foreseeable future. The Company is considering pursuing other remedies.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

Disclosure: Forward Looking Statements

This Quarterly Report contains forward-looking statements as that term is defined in the federal securities laws. The Company wishes to insure that any forward-looking statements are accompanied by meaningful cautionary statements in order to comply with the terms of the safe harbor provided by the Private Securities Litigation Reform Act of 1995. The events described in the forward-looking statements contained in this Quarterly Report may not occur. Generally these statements relate to business plans or strategies, projected or anticipated benefits or other consequences of our plans or strategies, projected or anticipated benefits of acquisitions to be made by us, projections involving anticipated revenues, earnings, or other aspects of our operating results. The words may , will , expect , believe , anticipate , project , plan , target , estimate , and continue , and their opposites and similar expressions are intended to identify forward-looking statements. We caution you that these statements are not guarantees of future performance or events and are subject to a number of uncertainties, risks, and other influences, many of which are beyond our control, that may influence the accuracy of the statements and the projections upon which the statements are based. Actual results may vary from these forward-looking statements for many reasons, including the following factors:

- adverse changes in economic or industry conditions in general or in the markets served by the Company and its customers
- actions by competitors
- inability to add new customers and/or maintain customer relationships
- inability to retain key employees.

The foregoing is not intended to be an exhaustive list of all factors that could cause actual results to differ materially from those expressed in forward-looking statements made by the Company. Investors are encouraged to review the risk factors set forth in the Company s most recent Form 10-K as filed with the Securities and Exchange Commission on March 31, 2006 and Amendment No. 1 of Form 10-K/A filed on September 29, 2006. Any one or more of these uncertainties, risks, and other influences could materially affect our results of operations and whether forward-looking statements made by us ultimately prove to be accurate. Our actual results, performance and achievements could differ materially from those expressed or implied in these forward-looking statements. We undertake no obligation to publicly update or revise any forward looking statements, whether from new information, future events, or otherwise.

Readers are further cautioned that the Company s financial results can vary from quarter to quarter, and the financial results for any period may not necessarily be indicative of future results.

The following discussion and analysis should be read in conjunction with the Company s consolidated financial statements and the notes thereto presented elsewhere herein. The discussion of results should not be construed to imply any conclusion that such results will necessarily continue in the future.

Critical Accounting Policies

Our significant accounting polices are described in Note 1 of the consolidated financial statements. In preparing our financial statements we made estimates and judgments that affect the results of our operations and the value of assets and liabilities we report. Our actual results may differ from these estimates under different assumptions or conditions.

For additional information regarding our critical accounting policies and estimates, see the section entitled Managements Discussion and Analysis of Financial Condition and Results of Operations in our annual report on Form 10-K for the year ended December 31, 2005.

Results of Operations

PPGI s business units products continue to fall into two product categories: optical components (including standard and custom optical components and assemblies, crystals, and crystal components), and laser accessories (including wavelength conversion, and optical Q-switches that employ nonlinear or electro-optical crystals to perform the function of wavelength conversion, or optical switching. Currently, its optical components product lines and services are brought to market via three PPGI business units: INRAD, Laser Optics, and MRC Optics. Laser accessories are brought to market by INRAD.

Revenues

Total sales for the three months ended September 30, 2006 were $3,049,000 as compared with total sales of $3,581,000 for the same three months in 2005; down 14.9%. Total sales for the nine months ended September 30, 2006 were $10,244,000 as compared with $9,906,000 for the same period last year; up 3.4%.

Sales of crystal components by INRAD, for the quarter, were strong and essentially unchanged from the third quarter of last year, while sales for the first nine months were up 4.0% from the same period in 2005. Sales of INRAD laser accessories increased 73% on a quarterly comparison to last year, but were down 35% on a year to year comparison through the first nine months. The decline resulted from the termination of a product distribution agreement, in January 2006, for the sale of laser pulse measurement instruments (auto-correllators) into the U.S. market, as previously reported.

Third quarter sales of custom optical components declined from second quarter levels due to a combination of delays in the awarding of certain follow-on production contracts from several customers and the completion of other production contracts that did not have a follow-on phase. Sales of custom optical components by Laser Optics declined 12.8% compared to the third quarter of last year, but were up 11.5% over last year for nine months. Shipment of MRC Optics branded products dipped in the third quarter to a low for this year and were down 31.6% from the same period in the prior year. This dip in sales was due to a decrease in shippable backlog from a delay in the awarding of follow-on production contracts in the first half. A delay in the delivery of customer supplied materials also factored into lower third quarter shipments. Despite these factors, MRC Optics sales for the first nine months were up 11.8% year-over-year.

Company sales were mainly to customers within the aerospace, defense, and process control and metrology industry sectors. Sales to two defense industry customers represented 14.2% and 13.7% of total revenues in this quarter. Sales to three defense industry customers represented 17.4%, 11.7%, and 10.0% of total revenues for the first nine months. In 2005, sales to one defense industry customer represented 10% of total revenues in the third quarter and two defense industry customers represented 12.4% and 10.8% of total revenues in the first nine months.

Product bookings for the quarter ended September 30, 2006 were down 16.1% to $5,155,000 from $6,142,000 for the same period last year but were up 63.8% from product bookings in the previous quarter. Product bookings for the first nine months were $10,575,000, as compared with $11,874,000 in the first nine months of 2005, down 10.9%.

In the third quarter of 2006, order intake for optical components was stronger than in the second quarter for both INRAD and Laser Optics, replenishing their backlogs. One Laser Optics defense industry customer revised its prior estimate upwards significantly for follow-on business in this year s second half and into the next year. Its order accounted for 22.2% of total new orders. A follow-on order from one INRAD defense industry customer, for proprietary INRAD filter crystal components used in their anti-aircraft missile protection system, accounted for 23.5% of total bookings in the third quarter. Order intake at MRC Optics was up sharply in comparison to bookings in the second quarter. One order, an anticipated follow-on production award that had been delayed earlier in the year, accounted for 11.4% of total new orders.

Product backlog on September 30, 2006 was approximately $7,843,000, down 5.4% from a backlog of $8,311,000 at the same point in 2005, but rose approximately 28.5% from a backlog of $6,104,000 on June 30, 2006. By comparison, product backlog was $7,876,000 on December 31, 2005,

The increase in backlog experienced during the third quarter is expected to have a positive impact on fourth quarter revenues and results.

Cost of Goods Sold

Decreased sales volumes in the third quarter, as anticipated, put pressure on the Company s gross margins. In the third quarter, management implemented cost reductions through cut-backs in labor and other variable manufacturing cost elements to compensate for lower volumes, where practical and appropriate. For the three-month period ended September 30, 2006, the cost of goods sold as a percentage of sales revenues increased to 71.0% from 69.1% in 2005, reflecting the impact of lower sales and backlog levels, this quarter. In dollar terms, third quarter cost of goods sold of $2,166,000 was down 12.5%, from last years third quarter total of $2,476,000, while sales revenues fell by 14.9%

For the nine month period ended September 30, 2006 the cost of goods sold percentage was 68.8% compared to 75.2% in the comparable period in 2005. For the full year 2005, the actual cost of goods sold percentage was 72.2%. For nine months, cost of goods sold was $7,052,000 or $397,000 lower as compared to $7,449,000 for the same period in 2005. Overall, the nine month cost of goods sold dropped 5.4% despite a revenue increase of 3.4% for the comparable period, reflecting these higher sales in addition to improved operational productivity and efficiencies.

Gross margin slackened to 29.0% in the third quarter, compared with 31.0% in the third quarter of last year, down due to lower sales. For the first nine months, the gross margin was 31.2% in 2006, up significantly from 24.8% in 2005.

Selling, General and Administrative Expenses

Selling, general and administrative expenses were $907,000 in the third quarter of 2006 and $788,000 in the third quarter of 2005 on a period over period revenue decrease of 14.9%. Selling, general and administrative expenses for the first nine months of 2006 were $2,763,000, up $218,000 or 8.6% when compared with $2,545,000 in the first nine months of 2005, on a revenue increase of 3.4%.

On average, quarterly selling, general and administrative expense is running at a rate of $921,000 or 27.0% of sales over nine months compared to nine months last year of $848,000 or 25.7% of sales.

Over nine months ended September 30, 2006, selling, general and administrative expenses increased due to a number of reasons. In 2006, the Company began expensing certain stock-based compensation (stock options) under FASB 123(R). For the first nine months of 2006, the SG&A portion of this category of expense is approximately $51,000, while it was -$ 0- in 2005. Additionally, the Company incurred higher expenses this year for IT (information technology) support in connection with the implementation, licensing fees and technical support for a new server and operating software, along with enhancements to its computer network, spam filtering software, back-up and security functionality. Additional expenses were also incurred for recruitment fees in connection with the Company s successful search for its new CFO. Legal and accounting expenses related to administrative corporate matters were also up over the comparable nine month period from last year. Additionally, significant non-recurring expenses were incurred in connection with the Company s investigation into the misappropriation of Company funds for personal use by its former CFO, as we reported in our Form 8-K filed on June 26, 2006, our second quarter 10Q, and our amended 2005 Form 10-K/A. These included additional costs for legal advice, forensic accounting consulting services and temporary accounting assistance. Director fees were up also resulting from special meetings of the Audit Committee of the Board of Directors necessitated by the events surrounding Mr. Miraglia. The total of extra non-recurring expenses related to the Miraglia investigation were approximately $140,000 for nine months of which approximately $59,000 were expensed in the third quarter of 2006.

Internal Research and Development Expenses

There were no research and development expenses for the quarter ended September 30, 2006 or for the full first nine months of 2006. This compares with $39,000 for the first nine months of 2005. Technical resources continued to be assigned to support of manufacturing and production process improvements, initiatives aimed at improving gross profit margins, and documentation of Company processes in preparation for certification under ISO 9001:2000.

Operating Profit (Loss)

The Company realized a loss from operations of $(24,000), or 0.7% of sales in the third quarter. This compares with an operating profit of $279,000 or 7.8% of sales for the third quarter of 2005. As discussed above, third quarter operating profit was negatively impacted by non-recurring S,G&A expenses related to the events surrounding the investigation of its former CFO in the amount of approximately $59,000, in addition to lower sales levels in the quarter.

For the nine months ended September 30, 2006, operating profit was $428,000 or 4.2%, up significantly from a loss of $(129,000) or (1.3)% of sales for the first nine months of 2005, including approximately $140,000 of non-recurring selling, general and administrative expenses related to the investigation discussed above. The year over year improvement in operating profit over nine months was attributable to both higher sales and an improved operating cost structure.

Other Income and Expense

Interest expense-net for the quarter was $102,000, down slightly from $108,000 last year. Interest expense net of $333,000 for the first nine months of 2006 fell by $27,000 from $360,000 in 2005. The reduction in interest expense-net reflects both the positive impact of interest income realized on this year s higher cash balances and an approximately $399,000 reduction in long term notes and capital lease obligations balances due to scheduled amortization payments, over the nine months of 2006.

In the third quarter of 2006, the Company received notification of a settlement for $300,000, the policy limit, from a claim under its employee dishonesty insurance policy and the Company reported the recovery as other income (expense) for the period. By comparison, in the third quarter of 2005, the Company realized a gain of $136,000 on the sale of excess precious metals.

The Company also incurred costs of $13,000 during the nine months ended September 30, 2006 to liquidate liabilities for property tax and unemployment and disability tax that surfaced late and were incurred as part of its acquisition in December 2003 of the assets and certain liabilities of the former Laser Optics, Inc.

Net Profit (Loss)

The Company had a net profit of $173,000 for the third quarter of 2006, as compared with a net profit of $308,000 for the third quarter of last year. For the nine months ended September 30, 2006, net profit was $381,000, comparing favorably with a net loss of $(349,000) in the same period last year.

Net Profit (Loss) Applicable to Common Shareholders and Earnings Per Common Share

Net profit applicable to common shareholders for the three months ended September 30, 2006 was $173,000 or $0.02 per share, basic and diluted and $308,000 or $0.04 per share-basic and $0.03 per share -diluted for 2005. For nine month ended September 30, 2006 net profit applicable to common shareholders was $147,000 or $0.02 net profit per share basic and diluted, after reflecting a preferred stock dividend of 134,000 common shares valued at $234,000 versus a net loss of $483,000 or $(0.07) per share basic and diluted, for nine months ended September 30, 2005, after a preferred stock dividend of 134,000 common shares valued at $134,000. The year over year increase in the amount of the preferred stock dividend resulted from an increase in market value of the Company shares on the date of the stock dividend.

Liquidity and Capital Resources

Net cash flow provided by operating activities was $1,063,000 for the first nine months of 2006, showing a significant improvement from a negative net cash flow provided by operating activities of $(647,000) in the first nine months of 2005.

This year s positive cash flow from operations over nine months was due to a number of factors including increased profitability on higher sales and improved margins, as well as a reduction in accounts receivable of $568,000. This was offset by a reduction in both accounts payable and customer advances in the amount of $266,000 and $272,000, respectively. In addition, other current assets rose by $359,000 including $300,000 for insurance proceeds receivable on a claim under our employee dishonesty policy related to our former CFO. Last year, operating cash flow for the first nine months was negatively affected by an increase in working capital requirements. Accounts receivable balances rose by $484,000 over the first nine months of 2005 corresponding with a drop in accounts payable balances of $216,000 and a reduction in customer advances of $223,000. These factors along with lower sales, process re-engineering activities and supply chain and operational inefficiencies, which have since been resolved, at the Company s new MRC Optics subsidiary, resulted in a net use of cash in operations of $647,000.

For the nine month period ended September 30, 2006, working capital requirements were funded from cash generated by operations. During the nine month period ended September 30, 2005, cash outflows were funded from cash reserves resulting from positive cash flow in 2004, from capital raised from equity and debt placements during 2004, and from the sale of non-productive and excess precious metal owned by the Company.

Capital expenditures for the nine months ended September 30, 2006 were $967,000, and were in part financed by proceeds from a promissory note of $700,000 from a major shareholder and debt holder The terms of the note call for repayment in equal monthly installments of interest and principal, commencing in March, 2006. The note bears an annual interest rate of 6.75%. During the first nine months of 2005, capital expenditures totaled $191,000.

This years capital expenditures includes significant expenditures for equipment required in the performance of certain specific contracts, and which additionally provides the Company with increased capability and a stronger competitive position in the manufacture of certain types of spherical and aspherical lenses. The capital expenditures in 2005 represent mainly expenditures for replacement of capital equipment at the end of its useful life.

In the first nine months of 2006, 115,000 stock options were exercised at a weighted average exercise price of $0.85 each and converted to 115,000 shares of common stock. No options were exercised or common shares issued in 2005.

As of September 30, 2006, cash and cash equivalents increased by $495,000 over nine months to $1,651,000. This compares to a decrease of $884,000 over nine months last year to a balance of $509,000 as of September 30, 2005.

The Company s management expects that cash flow from operations and use of its existing cash reserves will provide adequate liquidity for the Company s operations over the balance of 2006.

Management may from time to time continue to attempt to raise investment capital and to identify and to make investments in capital acquisitions, both in equipment and acquisition of complementary businesses, to pursue its objective of growth in shareholder value and to maintain a competitive edge in the markets that it serves. However, there can be no assurance that the Company will continue to pursue such acquisitions or the raising of acquisition capital as it examines all of its strategic options.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company believes that it has limited exposure to changes in interest rates from investments in certain money market accounts. The Company does not utilize derivative instruments or other market risk sensitive instruments to manage exposure to interest rate changes. The Company believes that a hypothetical 100 basis point adverse move in interest rates along the entire interest rate yield curve would not materially affect the fair value of the Company s interest sensitive money market accounts at September 30, 2006. Interest on notes and leases are at fixed rates for the term of the debt.

ITEM 4. CONTROLS AND PROCEDURES

a. Disclosure Controls and Procedures

As of the end of the period covered by this Quarterly report on Form 10-Q, we carried out an evaluation, with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures pursuant to Securities and Exchange Act Rule 13a-15. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective in ensuring that information required to be disclosed by us in the reports we file or submit under the Securities Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC s rules and forms.

b. Changes in Internal Controls Over Financial reporting.

In the Company s Form 10-Q filed on May 15, 2006, the Company reported that its internal controls for monitoring the use and reporting of charges on the Company s debit card were not adequate, and that it was taking steps to remedy that inadequacy, including limiting use of that card. The Company stated that it did not believe that this internal control issue had any material impact on the Company s financial statements based upon what had been uncovered.

On May 16, 2006, William Miraglia stepped down as the Company s chief financial officer, preceding the appointment of William Foote as new chief financial officer, but remained employed as controller of the Company in a non-officer capacity.

On June 26, 2006, the Company filed Form 8-K which provided additional information and an update on the situation

As a result, of an independent forensic investigation directed by the Audit Committee of the Company s Board of Directors which was concluded on July 26, 2006, the Company discovered widespread misuse by William Miraglia, its former CFO of its debit card for unauthorized and personal charges, several instances of unauthorized payments by check for non-business personal expenses, and other unauthorized transactions over a period of approximately six years, from the second quarter of 2000 through the second quarter of 2006. The amount totaled $860,000, including unauthorized charges on the Company s debit card of approximately $711,000.

In addition, the investigation by the audit committee revealed inadequate internal controls with respect to the Company s handling of disbursements by check. It discovered that Mr. Miraglia made payments totaling $94,500, by check, to the IRS with respect to a personal tax levy against him, as well as, other unapproved payments and misappropriation of funds totaling approximately $36,000. Mr. Miraglia was terminated for cause from his employment with the Company on June 14, 2006.

The investigation concluded that Mr. Miraglia acted alone and there was no evidence implicating any other employees in these or any other unauthorized and personal transactions. The results of this investigation have been reviewed with our Company auditors.

It was also discovered that Mr. Miraglia had created a control environment that contributed to the failure of Company employees charged with certain financial and accounting duties to exercise appropriate judgment, skepticism and objectivity in detecting and preventing these unauthorized personal transactions by Mr. Miraglia.

A claim to recover a portion of these losses under the Company s employee dishonesty insurance policy has been settled and the Company has recovered $300,000 from the insurance carrier, which is the policy limit. In addition, Mr. Miraglia has signed an agreement to make restitution to the Company. To date, he has repaid $5,000. The Company does not believe that any significant further recoveries from Mr. Miraglia are likely in the foreseeable future. The Company is considering pursuing other remedies.

The Company filed Amendment No 1 on Form 10-K/A with the Securities and Exchange Commission on September 29, 2006 to update Part 1 Risk Factors, Part II Item 9A Controls and Procedures, and also included additional information and disclosure about the final results of the Audit Committee s investigation, including the amount of these expenditures in the respective periods, discussed herein and in Note 2 of the Notes to the Financial Statements.

In light of the foregoing discoveries resulting from the investigation and from management s review of its internal control procedures, the Audit Committee directed the Company to strengthen its internal controls.

Steps taken include

a) recall and cancellation of the corporate debit card,

b) implementation of a policy requiring two authorized signatures on all checks in amounts of $5,000 or more. The Company has extended the policy requiring two authorized signatures to all wire transfers initiated from its bank,

19

c) establishing a written ethics policy to cover all employees and Directors which supplements the existing policy that covers senior financial executives,

d) improving internal procedures for reporting suspected ethics violations,

e) extending the requirement for the written approval of business expenses to corporate officers expense reports.

In addition, a joint meeting with the accounting staff, the Chief Executive Officer and the new Chief Financial Officer was held to review internal controls and procedures, to promote a control environment that emphasizes appropriate judgment, skepticism and objectivity and to reinforce each employees responsibility to safeguard Company assets and to report unusual, irregular or suspicious transactions to an independent officer or member of the Audit Committee. Further, the Company has commenced a program of identification and documentation of all critical internal controls and financial policies and procedures, which will be included within an Internal Control Policies and Procedures Manual.

Except as stated above, there were no other changes in our internal control over financial reporting that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None.

ITEM 1A. RISK FACTORS

There were no material changes in the risk factors previously disclosed in the Company s Report on Form 10-K filed with the Securities and Exchange Commission on March 31, 2006 and in Amendment No.1 to Form 10-KA filed with the Securities and Exchange Commission on September 29, 2006, except as reported in Form 10-Q dated June 30, 2006.

ITEM 3. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

11. An exhibit showing the computation of per-share earnings is omitted because the computation can be clearly determined from the material contained in this Quarterly Report on Form 10-Q.

31.1 Certificate of the Registrants Chief Executive Officer, Daniel Lehrfeld, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2 Certificate of the Registrants Chief Financial Officer, William J. Foote, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1 Certificate of the Registrants Chief Executive Officer, Daniel Lehrfeld, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2 Certificate of the Registrants Chief Financial Officer, William J. Foote, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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.

Photonic Products Group, Inc.

By: /s/ DANIEL LEHRFELD
Daniel Lehrfeld
President and Chief Executive Officer

By: /s/ WILLIAM J. FOOTE
William J. Foote
Chief Financial Officer

Date: November 14, 2006

21