

PHOTONIC PRODUCTS GROUP INC
Form 10-Q
August 12, 2011

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 JUNE 30, 2011

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)

(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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data file required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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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. (Check one):

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

Common shares of stock outstanding as of August 12, 2011:

11,707,353 shares

PHOTONIC PRODUCTS GROUP, INC AND SUBSIDIARIES

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PHOTONIC PRODUCTS GROUP, INC AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

| | June 30, 2011 (Unaudited) | December 31, 2010 (Audited) |
|---|---------------------------------|-----------------------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$4,282,280 | \$4,365,045 |
| Accounts receivable (net of allowance for doubtful accounts of \$15,000 in 2011 and 2010) | 1,834,278 | 2,224,592 |
| Inventories, net | 2,647,201 | 2,390,876 |
| Other current assets | 150,742 | 119,243 |
| Total current assets | 8,914,501 | 9,099,756 |
| Plant and equipment: | | |
| Plant and equipment, at cost | 14,926,991 | 14,879,508 |
| Less: Accumulated depreciation and amortization | (13,271,602) | (12,876,163) |
| Total plant and equipment | 1,655,389 | 2,003,345 |
| Precious Metals | 262,886 | 157,443 |
| Deferred Income Taxes | 408,000 | 408,000 |
| Goodwill | 311,572 | 311,572 |
| Intangible Assets, net | 555,170 | 594,452 |
| Other Assets | 44,499 | 47,235 |
| Total Assets | \$12,152,017 | \$12,621,803 |
| Liabilities and Shareholders' Equity | | |
| Current Liabilities: | | |
| Current portion of other long term notes | \$9,000 | \$9,000 |
| Accounts payable and accrued liabilities | 707,122 | 836,190 |
| Customer advances | 544,856 | 441,987 |
| Total current liabilities | 1,260,978 | 1,287,177 |
| Accrued Interest on Related Party Convertible Notes Payable | 525,000 | 1,125,000 |
| Related Party Convertible Notes Payable | 2,500,000 | 2,500,000 |
| Other Long Term Notes, net of current portion | 331,182 | 335,874 |
| Total liabilities | 4,617,160 | 5,248,051 |
| Commitments | | |
| Shareholders' Equity: | | |
| Common stock: \$.01 par value; 60,000,000 authorized shares; 11,711,953 shares issued at June 30, 2011 and 11,562,656 issued at December 31, 2010 | 117,120 | 115,626 |
| Capital in excess of par value | 17,623,160 | 17,402,528 |
| Accumulated deficit | (10,190,473) | (10,129,452) |
| | 7,549,807 | 7,388,702 |
| Less - Common stock in treasury, at cost (4,600 shares) | (14,950) | (14,950) |
| Total shareholders' equity | 7,534,857 | 7,373,752 |
| Total Liabilities and Shareholders' Equity | \$12,152,017 | \$12,621,803 |

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

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|--------------|------------------|--------------|
| | June 30, | | June 30, | |
| | 2011 | 2010 | 2011 | 2010 |
| Total revenue | \$3,221,234 | \$2,164,491 | \$6,462,668 | \$4,972,537 |
| Cost and expenses: | | | | |
| Cost of goods sold | 2,437,174 | 1,908,779 | 4,806,071 | 4,176,330 |
| Selling, general and administrative expenses | 847,784 | 869,695 | 1,657,029 | 1,649,690 |
| | 3,284,958 | 2,778,474 | 6,463,100 | 5,826,020 |
| Loss from operations | (63,724) | (613,983) | (432) | (853,483) |
| Other expense: | | | | |
| Interest expense—net | (32,026) | (34,915) | (64,215) | (69,884) |
| Gain on sale of plant and equipment | — | — | 3,626 | — |
| | (32,026) | (34,915) | (60,589) | (69,884) |
| Net loss before income taxes | (95,750) | (648,898) | (61,021) | (923,367) |
| Income tax (provision) benefit | — | — | — | — |
| Net loss | \$(95,750) | \$(648,898) | \$(61,021) | \$(923,367) |
| Net loss per common share—basic and diluted | \$(0.01) | \$(0.06) | \$(0.01) | \$(0.08) |
| Weighted average shares outstanding—basic and diluted | 11,697,353 | 11,556,729 | 11,622,483 | 11,494,929 |

See Notes to Condensed Consolidated Financial Statements (Unaudited)

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

| | Six Months Ended June 30, | |
|---|------------------------------|--------------|
| | 2011 | 2010 |
| Cash flows from operating activities: | | |
| Net loss | \$(61,021) | \$(923,367) |
| Adjustments to reconcile net loss to cash provided by operating activities: | | |
| Depreciation and amortization | 435,616 | 470,281 |
| 401K common stock contribution | 129,998 | 154,535 |
| Gain on sale of fixed assets | (3,626) | — |
| Stock based compensation | 73,498 | 80,085 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 390,314 | 589,607 |
| Inventories, net | (256,325) | 136,409 |
| Other current assets | (31,499) | (4,883) |
| Other assets | 2,736 | (3,092) |
| Accounts payable and accrued liabilities | (129,068) | 182,911 |
| Customer advances | 102,869 | (227,476) |
| Accrued Interest on Related Party Convertible Notes Payable | (600,000) | — |
| Total adjustments and changes | 114,513 | 1,378,377 |
| Net cash provided by operating activities | 53,492 | 455,010 |
| Cash flows from investing activities: | | |
| Capital expenditures | (50,752) | (64,665) |
| Purchase of precious metals | (105,443) | — |
| Proceeds from sale of plant and equipment | 6,000 | — |
| Net cash (used in) investing activities | (150,195) | (64,665) |
| Cash flows from financing activities: | | |
| Redemption of restricted stock units | (370) | (533) |
| Proceeds from exercise of stock options | 19,000 | 8,500 |
| Principal payments of notes payable-other | (4,692) | (4,510) |
| Net cash provided by financing activities | 13,938 | 3,457 |
| Net (decrease) increase in cash and cash equivalents | (82,765) | 393,802 |
| Cash and cash equivalents at beginning of period | 4,365,045 | 4,069,310 |
| Cash and cash equivalents at end of period | \$4,282,280 | \$4,463,112 |
| Supplemental Disclosure of Cash Flow Information: | | |
| Interest paid | \$682,000 | \$7,000 |
| Income taxes paid (refund) | \$— | \$(75,000) |

See Notes to Condensed Consolidated Financial Statements (Unaudited)

PHOTONIC PRODUCTS GROUP, INC AND SUBSIDIARIES
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited)

NOTE 1 –SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include the accounts of Photonic Products Group, Inc. and its subsidiaries (collectively, the “Company”). All significant intercompany balances and transactions have been eliminated.

The condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“U.S. GAAP”) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. In the opinion of management, all adjustments of a normal recurring nature considered necessary for a fair presentation have been included. The results of operations of any interim period are not necessarily indicative of the results of operations to be expected for the full fiscal year. For further information, refer to the consolidated financial statements and accompanying footnotes included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2010.

In preparing these consolidated financial statements, the Company has evaluated events and transactions for potential recognition or disclosure through the date the consolidated financial statements were issued.

Management Estimates

These unaudited condensed financial statements and related disclosures have been prepared in conformity with U.S. GAAP which requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses reported in those financial statements. Management evaluates its estimates and assumptions on an ongoing basis using historical experience and other factors, including the current economic environment, and makes adjustments when facts and circumstances dictate. As future events and their effects cannot be determined with precision, actual results could differ significantly from those estimates and assumptions. Significant changes, if any, in those estimates resulting from continuing changes in the economic environment will be reflected in the consolidated financial statements in future periods.

Inventories

Inventories are stated at the lower of cost (first-in-first-out basis) or market. The Company records a reserve for slow moving inventory as a charge against earnings for all products identified as surplus, slow-moving or discontinued. Excess work-in-process costs are charged against earnings whenever estimated costs-of-completion exceed unbilled revenues.

Inventories are comprised of the following and are shown net of inventory reserves:

| | June 30, 2011 | December 31, 2010 |
|---------------|------------------|----------------------|
| | (in thousands) | |
| Raw materials | \$ 1,097 | \$ 1,103 |

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| | | |
|--|----------|----------|
| Work in process, including manufactured parts and components | 876 | 806 |
| Finished goods | 674 | 482 |
| | \$ 2,647 | \$ 2,391 |

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Income Taxes

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

For the three months and six months ended June 30, 2011 and 2010, the Company did not record a current provision for either state or federal income taxes due to the losses incurred for both income tax and financial reporting purposes.

As of June 30, 2011, the Company has recognized a net deferred tax asset balance in the amount of \$408,000 which is the portion of the total net deferred tax balance of \$2,716,000 that the Company's management is reasonably assured will be fully utilized in future periods. In evaluating the Company's ability to recover deferred tax assets in future periods, management considers the available positive and negative factors, including the Company's recent operating results, the existence of cumulative losses and near term forecasts of future taxable income consistent with the plans and estimates that management uses to manage the underlying business. The Company's valuation allowance of \$2,308,000 as of June 30, 2011 will be maintained until management concludes that it is more likely than not that the remaining deferred tax assets will be realized. When sufficient positive evidence exists, the Company's income tax expense will be reduced by the decrease in its valuation allowance. An increase or reversal of the Company's valuation allowance could have a significant negative or positive impact on the Company's future earnings.

Net Income (Loss) per Common Share

Basic net income (loss) per common share is computed by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per common share is computed by dividing net income (loss) by the weighted average number of common shares and common stock equivalents outstanding, calculated on the treasury stock method for options, stock grants and warrants using the average market prices during the period, including potential common shares issuable upon conversion of outstanding convertible notes, except if the effect on the per share amounts is anti-dilutive.

For the three months and six months ended June 30, 2011 and 2010, the potential dilutive effect of all common stock equivalent shares outstanding have been excluded from the diluted computation because their effect is anti-dilutive. A total of 979,000 common stock options and grants, 1,875,000 warrants and 2,500,000 common shares issuable upon conversion of outstanding convertible notes were excluded from the computation of diluted net loss per common share for the three months and six months ended June 30, 2011. For the three months and six months ended June 30, 2010, 875,000 common stock options and grants, 1,875,000 warrants and 2,500,000 common shares issuable upon conversion of outstanding convertible notes were excluded from the computation of diluted net loss per common share.

Stock-Based Compensation

Stock-based compensation expense is estimated at the grant date based on the fair value of the award. The Company estimates the fair value of stock options granted using the Black-Scholes option pricing model. The fair value of restricted stock units granted is based on the closing market price of the Company's common stock on the date of the grant. The fair value of these awards, adjusted for estimated forfeitures, is amortized over the requisite service period of the award, which is generally the vesting period.

Recently Adopted Accounting Standards

In May 2011, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2011-04, “Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and International Financial Reporting Standards (“IFRS”).” This pronouncement was issued to provide a consistent definition of fair value and ensure that the fair value measurement and disclosure requirements are similar between U.S. GAAP and IFRS. ASU 2011-04 changes certain fair value measurement principles and enhances the disclosure requirements particularly for Level 3 fair value measurements. This pronouncement is effective for reporting periods beginning on or after December 15, 2011, with early adoption prohibited. The new guidance will require prospective application. The Company is currently evaluating the effect that the provisions of this pronouncement will have on its financial statements.

In June 2011, the FASB issued ASU No. 2011-05, “Presentation of Comprehensive Income” which was issued to enhance comparability between entities that report under U.S. GAAP and IFRS, and to provide a more consistent method of presenting non-owner transactions that affect an entity’s equity. ASU 2011-05 eliminates the option to report other comprehensive income and its components in the statement of changes in stockholders’ equity and requires an entity to present the total of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement or in two separate but consecutive statements. This pronouncement is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Early adoption of the new guidance is permitted and full retrospective application is required. The Company is currently evaluating the effect that the provisions of this pronouncement will have on its financial statements.

NOTE 2- EQUITY COMPENSATION PROGRAM AND STOCK BASED COMPENSATION

a) Stock Option Expense

The Company's results of operations for the three months ended June 30, 2011 and 2010 include stock-based compensation expense for stock option grants totaling \$41,112 and \$29,766, respectively. Such amounts have been included in the accompanying Consolidated Statements of Operations within cost of goods sold in the amount of \$17,287 (\$10,830 for 2010), and selling, general and administrative expenses in the amount of \$23,825 (\$18,936 for 2010).

The Company’s results of operations for the six months ended June 30, 2011 and 2010 include stock-based compensation expense for stock option grants totaling \$69,735 and \$59,532, respectively. Such amounts have been included in the accompanying Consolidated Statements of Operations within cost of goods sold in the amount of \$27,829 (\$21,660 for 2010), and selling, general and administrative expenses in the amount of \$41,906 (\$37,872 for 2010).

As of June 30, 2011 and 2010, there were \$308,133 and \$248,640 of unrecognized compensation costs, net of estimated forfeitures, related to non-vested stock options, which are expected to be recognized over a weighted average period of approximately 2.5 years and 2.5 years, respectively.

The following range of weighted-average assumptions were used to determine the fair value of stock option grants during the six months ended June 30, 2011 and 2010, respectively:

| Six Months Ended | |
|------------------|------|
| June 30, | |
| 2011 | 2010 |

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| | | | | |
|-------------------------|-------------|---|-------------|---|
| Expected Dividend yield | 0.00 | % | 0.00 | % |
| Expected Volatility | 100 | % | 236 | % |
| Risk-free interest rate | 3.4 | % | 3.7 | % |
| Expected term | 8 -10 years | | 8 -10 years | |

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b) Stock Option Activity

The following table represents stock options granted, exercised, and forfeited during the six month period ended June 30, 2011:

| Stock Options | Number of Options | Weighted Average Exercise Price per Option | Weighted Average Remaining Contractual Term (years) | Aggregate Intrinsic Value |
|--------------------------------|-------------------|--|---|---------------------------|
| Outstanding at January 1, 2011 | 798,476 | \$ 1.13 | 5.2 | \$ 63,105 |
| Granted | 209,700 | 0.98 | | |
| Exercised | (20,000) | 0.95 | | |
| Expired/Forfeited | (25,900) | 3.91 | | |
| Outstanding at June 30, 2011 | 962,276 | \$ 1.07 | 6.0 | \$ 79,989 |
| Exercisable at June 30, 2011 | 592,949 | \$ 1.09 | 4.1 | \$ 75,795 |

The following table represents non-vested stock options granted, vested and forfeited for the six months ended June 30, 2011.

| Non-vested Options | Options | Weighted-Average Grant-Date Fair Value |
|------------------------------|-----------|--|
| Non-vested - January 1, 2011 | 254,525 | \$ 1.14 |
| Granted | 209,700 | \$ 0.89 |
| Vested | (91,998) | \$ 1.20 |
| Forfeited | (2,900) | \$ 0.92 |
| Non-vested - June 30, 2011 | 369,327 | \$ 0.99 |

The total fair value of options vested during the six months ended June 30, 2011 and 2010 was \$110,035 and \$60,000, respectively.

c) Restricted Stock Unit Awards

There were 15,000 restricted stock units granted under the 2010 Equity Compensation Program during the six months ended June 30, 2011. These grants vest over a three year period contingent on continued employment or service during the vesting period.

There were no grants during the six months ended June 30, 2010.

The Company's results of operations for the three months ended June 30, 2011 and 2010 include stock-based compensation expense for restricted stock unit grants totaling \$2,488 and \$11,613, respectively. Such amounts have been included in the accompanying Consolidated Statements of Operations within cost of goods sold in the amount of \$0 (\$1,335 for 2010), and selling, general and administrative expenses in the amount of \$2,488 (\$10,278 for 2010).

The Company's results of operations for the six months ended June 30, 2011 and 2010 include stock-based compensation expense for restricted stock unit grants totaling \$3,763 and \$20,553, respectively. Such amounts have been included in the accompanying Consolidated Statements of Operations within cost of goods sold in the amount of \$0 (\$2,670 for 2010), and selling, general and administrative expenses in the amount of \$3,763 (\$17,883 for 2010).

A summary of the Company's non-vested restricted stock units at June 30, 2011 is presented below:

| | Restricted Stock Units | Weighted-Average Grant-Date Fair Value |
|------------------------------|---------------------------|--|
| Non-vested - January 1, 2011 | 6,998 | \$ 3.59 |
| Granted | 15,000 | 0.97 |
| Vested | (4,998) | \$ 4.00 |
| Forfeited | — | — |
| Non-vested – June 30, 2011 | 17,000 | \$ 1.16 |

NOTE 3- STOCKHOLDERS' EQUITY

For the six months ended June 30, 2011, the Company issued 124,669 common shares to the PPGI 401k plan as a match to employee contributions for 2010 and 4,628 shares of common stock were issued on the vesting of employee stock grants, net of shares tendered to cover withholding taxes.

In addition, 20,000 common shares were issued for proceeds of \$19,000 in connection with the exercise of stock options during the six month period.

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

Caution Regarding 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 the Company's plans or strategies, projected or anticipated benefits of acquisitions made by the Company, projections involving anticipated revenues, earnings, or other aspects of the Company's operating results. The words "may", "will", "expect", "believe", "anticipate", "project", "plan", "intend", "estimate", and "continue" and similar expressions are intended to identify forward-looking statements. The Company cautions 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 the Company's control, that may influence the accuracy of the statements and the projections upon which the statements are based. Factors which may affect the Company's results include, but are not limited to, the risks and uncertainties discussed in Items 1A, 7 and 7A of the Company's most recent Annual Report on Form 10-K for the year ended December 31, 2010, as filed with the Securities and Exchange Commission on March 31, 2011. Any one or more of these uncertainties, risks, and other influences could materially affect the Company's results of operations and whether forward-looking statements made by the Company ultimately prove to be accurate. 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 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. The Company's actual results, performance and achievements could differ materially from those expressed or implied in these forward-looking statements. The Company undertakes no obligation to publicly update or revise any forward looking statements, whether from new information, future events, or otherwise.

Critical Accounting Policies and Estimates

Our significant accounting policies are described in Note 1 of the accompanying consolidated financial statements and further discussed in our annual financial statements included in our annual report on Form 10-K for the year ended December 31, 2010. In preparing our condensed consolidated financial statements, we made estimates and judgments that affect the results of our operations and the value of assets and liabilities we report. These include estimates used in evaluating goodwill and intangibles for impairment such as market multiples used in determining the fair value of reporting units, discount rates applicable in determining net present values of future cash flows, projections of future sales, earnings and cash flow and capital expenditures. It also includes estimates about the amount and timing of future taxable income in determining the Company's valuation allowance for deferred income tax assets. 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 "Management's Discussion and Analysis of Financial Condition and Results of Operations" in our annual report filed with the Securities and Exchange Commission on Form 10-K for the year ended December 31, 2010.

Results of Operations

Photonic Products Group, Inc.'s business falls into two general product types: Optical Components which develops, manufactures and delivers high-end precision custom optics and thin film optical coating services, and Laser System Devices and Instrumentation which includes the growth and fabrication of crystalline materials with electro-optic, non-linear and optical properties for use in both standard and custom products and the manufacture of crystal based devices and associated instrumentation. The Optical Components product lines and services are brought to market through three brands: INRAD, Laser Optics and MRC Optics ("MRC"). The Laser Systems Devices and Instrumentation are manufactured and sold by INRAD. The Company operates manufacturing facilities in New Jersey and Florida.

Revenue

Sales for the three months ended June 30, 2011 were \$3,221,000, an increase of 48.8% compared with \$2,164,000 in the second quarter of 2010. Sales for the six months ended June 30, 2011 were \$6,463,000, an increase of 30% compared with \$4,973,000 for the six months ended June 30, 2010. This was mainly due to an increase in orders from both new customers and from existing customers in the commercial markets we serve. Sales of optical components increased 34.0% and 55.2%, respectively, for the six months ended June 30, 2011 and the quarter ended June 2011 compared with the prior year and sales of laser systems increased 19.8% and 34.3% over the same periods. Sales to the defense market were down 7.5% for the first six months of 2011 compared to the same periods in 2010.

Sales to major customers who represent more than 10% of period sales, increased as a percentage of total sales to 48.9% in the first six months of 2011 from 42.5% in the same period in 2010. In addition, sales to major customers increased to 51.6% in the second quarter of 2011 from 17.8% in the second quarter of 2010.

The Company's top five customers represented 58.8% of total sales in the six month period ended June 30, 2011, up slightly from 58.1% in the same period last year. Although the percentage of top five customer sales did not increase significantly, one large commercial account was added to the top five customer ranks in the current period, replacing a defense customer in the comparable period last year.

Orders for the first six months of 2011 increased to \$6.2 million compared to \$4.2 million in the first six months of 2010, up 32.3%.

Order backlog increased to \$5.1 million at June 30, 2011 compared to a backlog of \$3.6 million at June 30, 2010.

Cost of Goods Sold

For the three months ended June 30, 2011, cost of goods sold decreased as a percent of sales to 75.7% from 88.2% in 2010. For the six months ended June 30, 2011 cost of goods sold decreased to 74.4% as a percentage of sales from 84.0% in the same period in 2010.

In dollar terms, cost of goods sold was \$2,437,000 compared to \$1,909,000 for the three months ended June 30, 2011, up \$528,000 or 27.7%. For the six months ended June 30, 2011 and 2010, cost of goods sold was \$4,806,000, and \$4,176,000, respectively, an increase of \$630,000 or 15.1%. The increases were attributable to higher sales in each of the comparable periods in the prior year.

In the second quarter and six months ended June 30, 2011, manufacturing wages and salaries and related fringe benefits increased by 12.4% and 8.3%, respectively, principally due to an increase in direct labor to meet the increased demand and an increase in fringe benefits costs compared with the same periods in 2010. As a percentage of sales, these manufacturing labor costs decreased both in the in second quarter and the six months ended June 30, 2011 as compared with the same period last year.

Material costs increased in both the second quarter and six months ended June 30, 2011 as compared with the same period in 2010 in dollar terms and as a percentage of sales due to a shift in the product mix to sales with a higher material cost in 2011, compared to 2010.

Overall, gross margin in the second quarter of 2011 was \$784,000 or 24.3% of sales, up compared with \$256,000 or 11.8% of sales in the second quarter of 2010 and for the six months ended June 30, 2011, gross margin also increased to \$1.7 million or 25.6% of sales compared with \$796,000 or 16.0% in the same period of 2010, reflecting the factors discussed and the impact of higher sales levels during the periods on the Company's relatively fixed cost structure.

Selling, General and Administrative Expenses

Selling, general and administrative expenses ("SG&A" expenses) in the three and six months ended June 30, 2011 were \$848,000 or 26.3% of sales and \$1,657,000 or 25.6% of sales, respectively, compared to \$870,000 or 40.2% of sales and \$1,650,000 or 33.2% of sales, respectively, for the same periods in 2010.

Overall, the major categories of SG&A expenses have remained relatively unchanged both on a year-to-date and quarter over quarter basis as the Company has continued to tightly manage discretionary spending.

Loss from Operations

The Company had an operating loss of \$63,000 in the three months ended June 30, 2011 compared with an operating loss of \$614,000 in the three months ended June 30, 2010, an improvement of \$550,000. For the six months ended June 30, 2011, the Company ended with a small operating loss of \$433, down significantly from an operating loss of \$853,000 in the same period last year.

Other Income and Expense

For the three months ended June 30, 2011, net interest expense was \$32,000, a slight decrease from \$35,000 in the second quarter of last year. For the six months ended June 30, 2011, net interest expense was \$64,000 compared to \$70,000 in the same period in 2010.

Interest expense for the three and six months ended June 30, 2011 was \$41,000 and \$82,000, respectively, which was unchanged from the comparable periods in 2010. Interest income was \$9,000 and \$18,000 in second quarter of 2011 and six months ended June 30, 2011 higher than interest income of \$6,000 and \$12,000 in the comparable periods last year.

In the first quarter of 2011, the Company sold surplus equipment and recorded a gain of \$4,000 on the sale.

Income Taxes

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

For the three months and six months ended June 30, 2011 and 2010, the Company did not record a current provision for either state or federal income taxes due to the losses incurred for both income tax and financial reporting purposes.

As of June 30, 2011, the Company has recognized a net deferred tax asset balance in the amount of \$408,000 which is the portion of the total net deferred tax balance of \$2,716,000 that the Company's management is reasonably assured will be fully utilized in future periods. In evaluating the Company's ability to recover deferred tax assets in future periods, management considers the available positive and negative factors, including the Company's recent operating results, the existence of cumulative losses and near term forecasts of future taxable income consistent with the plans and estimates that management uses to manage the underlying business. The Company's valuation allowance of \$2,308,000 as of June 30, 2011 will be maintained until management concludes that it is more likely than not that the remaining deferred tax assets will be realized. When sufficient positive evidence exists, the Company's income tax expense will be reduced by the decrease in its valuation allowance. An increase or reversal of the Company's valuation allowance could have a significant negative or positive impact on the Company's future earnings.

Net Loss

For the six months ended June 30, 2011, the Company had a net loss of \$61,000 which compared favorably with a net loss of \$923,000 for the same period in 2010. The Company had net loss of \$96,000 for the three months ended June 30, 2011 compared with a net loss of \$649,000 for the three months ended June 30, 2010. The improvement in 2011 was attributable to the positive effect of the 30.0% and 48.8% increases in sales volumes for the six months and second quarter, respectively, and improvements in gross profit margins, as discussed above.

Liquidity and Capital Resources

The Company's primary source of cash has been from operating cash flows. Other sources of cash include proceeds received from the exercise of stock options and warrants in return for the issuance of common stock. The Company's major use of cash in the past two years has been for repayment and servicing of outstanding debt and for capital expenditures. Based upon the current level of operations we believe our existing cash resources, as well as cash flows from future operating activities, will be adequate to meet our anticipated requirements for working capital, principal and interest payments on outstanding debt, capital expenditures and other operating needs over next twelve months.

The following table summarizes net cash provided by (used in) operating, investing and financing activities for the six months ended June 30, 2011 and 2010:

| | Six Months Ended June 30, | |
|--|------------------------------|--------|
| | 2011 | 2010 |
| | (In thousands) | |
| Net cash provided by operating activities | \$ 53 | \$ 455 |
| Net cash (used in) investing activities | (150) | (65) |
| Net cash provided by financing activities | 14 | 4 |
| Net (decrease) increase in cash and cash equivalents | \$ (83) | \$ 394 |

Net cash provided by operating activities was \$53,000 for the six months ended June 30, 2011, compared to \$455,000 in the same period last year. The decrease in cash provided by operating activities compared to the corresponding period last year resulted primarily from an increase in working capital requirements necessary to support the Company's current level of business activity. In particular, inventory levels increased by \$256,000 to \$2,647,000 at June 30, 2011 compared to a decrease of \$136,000 in the six month period ended June 30, 2010. The increase in inventory is primarily attributable to an increase in demand and timing of deliveries for orders in the current period. In addition, the Company paid accrued interest of \$600,000 and an additional \$75,000 in current interest on convertible notes payable. At a minimum, the Company expects to make a payment of \$37,500 each quarter over the balance of 2011 and through the maturity date of the notes to satisfy the amounts of future interest accruing in each quarter.

Capital expenditures for the six months ended June 30, 2011 were \$51,000 and \$65,000 in the comparable period last year. Management continued its review of planned capital expenditures to identify and defer expenditures, where practical, to minimize the impact on the Company's cash flows over the balance of the year.

In the six months ended June 30, 2011, the Company purchased specialized tools fabricated from precious metals in the amount of \$105,000.

Net cash provided by financing activities during the first six months ending June 30, 2011 totaled \$14,000 compared to \$4,000 provided in the comparable period in 2010. This consisted primarily of proceeds from the exercise of stock options for \$19,000 in 2011 and \$9,000 in 2010, offset by principal payments on long term notes of \$5,000 in each period, respectively.

Overall, the Company had a net decrease in cash and cash equivalents of \$83,000 in the six months ended June 30, 2011 compared with an increase of \$394,000 in the corresponding period last year.

Cash and cash equivalents at June 30, 2011 were \$4,282,000. At December 31, 2010, the Company had \$4,365,000 in cash and cash equivalents.

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.

ITEM 4. CONTROLS AND PROCEDURES

a. Disclosure Controls and Procedures

Our Chief Executive Officer and Chief Financial Officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) as of June 30, 2011 (the "Evaluation Date"), have concluded that as of the Evaluation Date, 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 Exchange Act (1) is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms, and (2) is accumulated and communicated to our management, including the Chief Executive Officer and the Chief Financial Officer, as appropriate to allow for timely decisions regarding required disclosure.

b. Changes in Internal Controls Over Financial Reporting

There were no changes in our internal control over financial reporting during the 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

Not applicable

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UNDER SENIOR SECURITIES

None.

ITEM 4. [Reserved]

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 Registrant's Chief Executive Officer, Joseph J. Rutherford, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certificate of the Registrant's Chief Financial Officer, William J. Foote, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certificate of the Registrant's Chief Executive Officer, Joseph J. Rutherford, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certificate of the Registrant's Chief Financial Officer, William J. Foote, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101 The following financial information from Photonic Products Group, Inc.'s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2011 formatted in Extensible Business Reporting Language (XBRL): (i) Condensed Consolidated Balance Sheets, (ii) Condensed Consolidated Statements of Operations, (iii) Condensed Consolidated Statements of Cash Flows, and (iv) the Notes to the Condensed Consolidated Financial Statements.*

*

Users of this interactive data file are advised pursuant to Rule 406T of Regulations S-T that this interactive data file is deemed not filed or part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.

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/ Joseph J. Rutherford
Joseph J. Rutherford
President and Chief Executive Officer

By: /s/ William J. Foote
William J. Foote
Chief Financial Officer,
Secretary and Treasurer

Date: August 12, 2011