

PHOTONIC PRODUCTS GROUP INC  
Form 10-Q  
May 14, 2007

**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 **March 31, 2007**

**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

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

Common shares of stock outstanding as of May 14, 2007:

**8,965,987 shares**

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**PHOTONIC PRODUCTS GROUP, INC. AND SUBSIDIARIES**

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## PHOTONIC PRODUCTS GROUP, INC AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

|                                                                                                                                       | March 31,<br>2007<br>(Unaudited) | December 31,<br>2006 |
|---------------------------------------------------------------------------------------------------------------------------------------|----------------------------------|----------------------|
| <b>Assets</b>                                                                                                                         |                                  |                      |
| <b>Current assets:</b>                                                                                                                |                                  |                      |
| Cash and cash equivalents                                                                                                             | \$ 3,247,841                     | \$ 3,078,052         |
| Accounts receivable (net of allowance for doubtful accounts of \$15,000 in 2007 and 2006)                                             | 2,195,254                        | 2,396,486            |
| Inventories                                                                                                                           | 2,571,726                        | 2,336,033            |
| Other current assets                                                                                                                  | 147,512                          | 176,587              |
| <b>Total Current Assets</b>                                                                                                           | <b>8,162,333</b>                 | <b>7,987,158</b>     |
| <b>Plant and equipment,</b>                                                                                                           |                                  |                      |
| Plant and equipment at cost                                                                                                           | 13,489,453                       | 13,459,212           |
| Less: Accumulated depreciation and amortization                                                                                       | (9,428,527)                      | (9,164,031)          |
| Total plant and equipment                                                                                                             | 4,060,926                        | 4,295,181            |
| <b>Precious Metals</b>                                                                                                                | <b>130,732</b>                   | <b>130,732</b>       |
| <b>Goodwill</b>                                                                                                                       | <b>1,869,646</b>                 | <b>1,869,646</b>     |
| <b>Intangible Assets</b>                                                                                                              | <b>889,068</b>                   | <b>908,708</b>       |
| <b>Other Assets</b>                                                                                                                   | <b>127,389</b>                   | <b>124,835</b>       |
| <b>Total Assets</b>                                                                                                                   | <b>\$ 15,240,094</b>             | <b>\$ 15,316,260</b> |
| <b>Liabilities and Shareholders' Equity</b>                                                                                           |                                  |                      |
| <b>Current Liabilities:</b>                                                                                                           |                                  |                      |
| Current portion of notes payable - Other                                                                                              | \$ 100,079                       | \$ 100,079           |
| Accounts payable and accrued liabilities                                                                                              | 2,113,967                        | 2,495,398            |
| Customer advances                                                                                                                     | 769,891                          | 987,963              |
| Current obligations under capital leases                                                                                              | 152,769                          | 196,350              |
| Convertible note payable due within one year                                                                                          | 1,000,000                        |                      |
| <b>Total current liabilities</b>                                                                                                      | <b>4,136,706</b>                 | <b>3,779,790</b>     |
| <b>Secured and Convertible Notes Payable</b>                                                                                          | <b>4,200,000</b>                 | <b>5,200,000</b>     |
| <b>Other Long Term Notes</b>                                                                                                          | <b>1,028,239</b>                 | <b>1,052,680</b>     |
| <b>Capital Lease Obligations</b>                                                                                                      | <b>27,788</b>                    | <b>47,087</b>        |
| <b>Total liabilities</b>                                                                                                              | <b>9,392,733</b>                 | <b>10,079,557</b>    |
| <b>Shareholders' equity:</b>                                                                                                          |                                  |                      |
| 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 respectively                              | 2,082,000                        | 2,082,000            |
| Common stock: \$.01 par value; 60,000,000 authorized 8,006,207 shares issued at March 31, 2007 and 7,882,074 issued December 31, 2006 | 80,061                           | 78,820               |
| Capital in excess of par value                                                                                                        | 12,101,372                       | 11,926,815           |
| Accumulated deficit                                                                                                                   | (8,901,122)                      | (9,335,982)          |
|                                                                                                                                       | 5,862,311                        | 5,251,653            |
| Less: Common stock in treasury, at cost (4,600 shares respectively)                                                                   | (14,950)                         | (14,950)             |
| <b>Total Shareholders' Equity</b>                                                                                                     | <b>5,847,361</b>                 | <b>5,236,703</b>     |
| <b>Total Liabilities &amp; Shareholders' Equity</b>                                                                                   | <b>\$ 15,240,094</b>             | <b>\$ 15,316,260</b> |

See Notes to Consolidated Financial Statements (Unaudited)



## PHOTONIC PRODUCTS GROUP, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

|                                                     | Three Months Ended March 31, |                   |
|-----------------------------------------------------|------------------------------|-------------------|
|                                                     | 2007                         | 2006              |
| <b>Total Revenue</b>                                | \$ 3,540,874                 | \$ 3,662,776      |
| <b>Cost and Expenses:</b>                           |                              |                   |
| Cost of goods sold                                  | 2,159,374                    | 2,475,159         |
| Selling, general & administrative expenses          | 856,728                      | 873,136           |
| <b>Total Cost and Expenses</b>                      | <b>3,016,102</b>             | <b>3,348,295</b>  |
| <b>Income from operations</b>                       | <b>524,772</b>               | <b>314,481</b>    |
| <b>Other expense:</b>                               |                              |                   |
| Interest expense, net                               | 74,912                       | 112,828           |
| <b>Net income before income taxes</b>               | <b>449,860</b>               | <b>201,653</b>    |
| Provision for income taxes                          | 15,000                       |                   |
| <b>Net income applicable to common shareholders</b> | <b>\$ 434,860</b>            | <b>\$ 201,653</b> |
| <b>Net income per common share basic</b>            | <b>\$ 0.06</b>               | <b>\$ 0.03</b>    |
| <b>Net income per common share diluted</b>          | <b>\$ 0.04</b>               | <b>\$ 0.02</b>    |
| <b>Weighted average shares outstanding basic</b>    | <b>7,902,763</b>             | <b>7,311,537</b>  |
| <b>Weighted average shares outstanding diluted</b>  | <b>13,491,585</b>            | <b>12,539,640</b> |

See Notes to Consolidated Financial Statements (Unaudited)

## PHOTONIC PRODUCTS GROUP, INC AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

|                                                                                      | Three Months Ended March 31, |                     |
|--------------------------------------------------------------------------------------|------------------------------|---------------------|
|                                                                                      | 2007                         | 2006                |
| <b>Cash flows from operating activities:</b>                                         |                              |                     |
| Net income                                                                           | \$ 434,860                   | \$ 201,653          |
| <b>Adjustments to reconcile net income to cash provided by operating activities:</b> |                              |                     |
| Depreciation and amortization                                                        | 284,136                      | 261,653             |
| 401K common stock contribution                                                       | 166,693                      | 150,501             |
| Stock based compensation                                                             | 9,105                        | 30,204              |
| <b>Changes in assets and liabilities:</b>                                            |                              |                     |
| Accounts receivable                                                                  | 201,232                      | 99,144              |
| Inventories                                                                          | (235,693 )                   | (61,052 )           |
| Other current assets                                                                 | 29,075                       | (131,168 )          |
| Other assets                                                                         | (2,554 )                     | (10,950 )           |
| Accounts payable and accrued liabilities                                             | (381,431 )                   | (120,995 )          |
| Customer advances                                                                    | (218,072 )                   | 282                 |
| Total adjustments                                                                    | (147,509 )                   | 217,619             |
| <b>Net cash provided by operating activities</b>                                     | <b>287,351</b>               | <b>419,272</b>      |
| Capital expenditures                                                                 | (30,241 )                    | (800,071 )          |
| <b>Net cash used in investing activities</b>                                         | <b>(30,241 )</b>             | <b>(800,071 )</b>   |
| <b>Cash flows from financing activities:</b>                                         |                              |                     |
| Proceeds from promissory note                                                        |                              | 700,000             |
| Principal payments of notes payable                                                  | (24,441 )                    | (59,713 )           |
| Principal payments of capital lease obligations                                      | (62,880 )                    | (61,396 )           |
| <b>Net cash (used in) provided by financing activities</b>                           | <b>(87,321 )</b>             | <b>578,891</b>      |
| <b>Net increase in cash and cash equivalents</b>                                     | <b>169,789</b>               | <b>198,092</b>      |
| <b>Cash and cash equivalents at beginning of period</b>                              | <b>3,078,052</b>             | <b>1,156,563</b>    |
| <b>Cash and cash equivalents at end of period</b>                                    | <b>\$ 3,247,841</b>          | <b>\$ 1,354,655</b> |

See Notes to Consolidated Financial Statements (Unaudited)

## 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, 2006 and 2005 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.

**Inventories**

Inventories are stated at the 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. Costs include labor, material and overhead.

Inventories are comprised of the following:

|                                                              | March 31,<br>2007 | December 31,<br>2006 |
|--------------------------------------------------------------|-------------------|----------------------|
| Raw materials                                                | \$ 720,000        | \$ 635,000           |
| Work in process, including manufactured parts and components | 1,398,000         | 1,213,000            |
| Finished goods                                               | 454,000           | 488,000              |
|                                                              | \$ 2,572,000      | \$ 2,336,000         |

**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**

The basic net income per share is computed using the weighted average number of common shares outstanding for the applicable period. The diluted income per share is computed using the weighted average number of common shares plus potential common equivalent shares outstanding, including the additional dilution related to the conversion of stock options, warrants, convertible preferred shares, and potential common shares issuable upon conversion of outstanding convertible notes, except if the effect on the per share amounts 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<br>March 31, 2007 |                         |                     | Three Months Ended<br>March 31, 2006 |                         |                     |
|-------------------------------------------------|--------------------------------------|-------------------------|---------------------|--------------------------------------|-------------------------|---------------------|
|                                                 | Income<br>(Numerator)                | Shares<br>(Denominator) | Per Share<br>Amount | Income<br>(Numerator)                | Shares<br>(Denominator) | Per Share<br>Amount |
| <b>Basic Earnings Per Share:</b>                |                                      |                         |                     |                                      |                         |                     |
| Net Income Applicable to<br>Common Shareholders | \$ 434,860                           | 7,902,763               | \$ 0.06             | \$ 201,653                           | 7,311,537               | \$ 0.03             |
| <b>Effect of dilutive securities</b>            |                                      |                         |                     |                                      |                         |                     |
| Convertible Debt                                | 52,500                               | 3,500,000               |                     | 52,500                               | 3,500,000               |                     |
| Convertible Preferred<br>Stock                  |                                      | 500,000                 |                     |                                      | 500,000                 |                     |
| Warrants                                        |                                      | 921,457                 |                     |                                      | 474,306                 |                     |
| Options                                         |                                      | 667,365                 |                     |                                      | 753,797                 |                     |
| <b>Diluted Earnings Per<br/>Share:</b>          |                                      |                         |                     |                                      |                         |                     |
| Net Income Applicable to<br>Common Shareholders | \$ 487,360                           | 13,491,585              | \$ 0.04             | \$ 254,153                           | 12,539,640              | \$ 0.02             |
| <b>Stock Based Compensation</b>                 |                                      |                         |                     |                                      |                         |                     |

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 March 31, 2007 include share-based compensation expense totaling \$9,105. Such amounts have been included in the Consolidated Statements of Operations within cost of goods sold (\$2,442), and selling, general and administrative expenses (\$6,663), as appropriate. For three months ended March 31, 2006, share-based compensation expense was \$30,204 including \$4,398 within cost of goods sold and \$25,806 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 option compensation expense in 2007 and 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 three months ended March 31, 2007 and 2006 was \$1.47 and \$1.43, respectively. The fair value of options at the date of grant was estimated using the Black-Scholes option pricing model. During 2007, 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 options. The Company uses the available rate on zero-coupon government obligations with a remaining term equal to the expected life of the options as the basis for its risk-free interest rate.

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

|                          | Three Months Ended |   |                |   |
|--------------------------|--------------------|---|----------------|---|
|                          | March 31, 2007     |   | March 31, 2006 |   |
| Expected term (in years) | 10                 |   | 10             |   |
| Expected volatility      | 144.9              | % | 119.4          | % |
| Expected dividend yield  | 0                  | % | 0              | % |
| Risk-free interest rate  | 4.7                | % | 5.2            | % |

The Company granted 29,039 options under the Plan during the three months ended March 31, 2007 at an exercise price of \$1.50 per share. In the three months ended March 31, 2006, 67,200 options were granted at an exercise price of \$1.50 per share. Stock grants are issued at a price that is equal to the closing market price on the date of each grant.

The following table represents our stock options granted, exercised, and forfeited during the first three months of 2007.

| Stock Options                  | Number of Options | Weighted Average Exercise Price per Option | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
|--------------------------------|-------------------|--------------------------------------------|---------------------------------------------|---------------------------|
| Outstanding at January 1, 2007 | 1,879,700         | \$ 1.25                                    | 4.6 years                                   | \$ 0.42                   |
| Granted                        | 29,039            | \$ 1.50                                    |                                             |                           |
| Exercised                      | -0-               |                                            |                                             |                           |
| Forfeited/expired              | -0-               |                                            |                                             |                           |
| Outstanding at March 31, 2007  | 1,908,739         | \$ 1.23                                    | 5.09 years                                  | \$ 0.52                   |
| Exercisable at March 31, 2007  | 1,839,618         | \$ 1.22                                    | 4.87 years                                  | \$ 0.53                   |

The following table represents non-vested stock options granted, vested, and forfeited during the three months ended March 31, 2007.

| <b>Non-vested Options</b>  | <b>Options</b> | <b>Weighted-Average</b>      |
|----------------------------|----------------|------------------------------|
|                            |                | <b>Grant-Date Fair Value</b> |
| Non-vested January 1, 2007 | 146,424        | \$ 0.85                      |
| Granted                    | 29,039         | \$ 1.50                      |
| Vested                     | (106,343 )     | \$ 0.50                      |
| Forfeited                  | -0-            |                              |
| Non-vested March 31, 2007  | 69,120         | \$ 1.54                      |

As of March 31, 2007, there was \$89,896 of unrecognized compensation costs, net of estimated forfeitures, related to non-vested stock options, which is expected to be recognized over a weighted average period of approximately 2.8 years. The total fair value of shares vested during the three months ended March 31, 2007 and 2006, was \$65,000 and \$152,000, respectively.

#### **NOTE 2 CONVERSION OF CONVERTIBLE PREFERRED SHARES**

On April 16, 2007, the Company called for the redemption of its Series A 10% Convertible Preferred Stock (the Series A ). On April 30, 2007, the Company received notice that Clarex Limited, the holder of all the shares of the Series A, elected to convert the 500 Preferred shares into 500,000 shares of the Company's common stock, in accordance with the Series A Agreement.

#### **NOTE 3 IMPACT OF UNAUTHORIZED PERSONAL TRANSACTIONS BY FORMER CFO**

As previously reported, 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.

These transactions were entered by the former CFO into the Company's accounts 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 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. A total of \$47,000 was recorded in Selling, General and Administrative expenses in the first quarter of 2006. A claim to recover a portion of these losses under the Company's employee dishonesty insurance policy was settled in the third quarter of 2006 in the amount of \$300,000, the policy limit, and has been reflected in the Company's financial results for 2006.

As a result of the foregoing discoveries, Mr. Miraglia was terminated for cause from his employment with the Company on June 14, 2006. Upon termination of his employment, Mr. Miraglia 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 recoveries from Mr. Miraglia are likely in the near term, but the Company is keeping all of its options open. The Company has been cooperating with the U.S. Attorney's office in its ongoing investigation into this matter.

## **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 30, 2007. 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. Except as required by law, 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 policies 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 filed with the Securities and Exchange Commission on Form 10-K for the year ended December 31, 2006.



## 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 instruments, that employ nonlinear or electro-optical crystals to perform the function of wavelength conversion, or optical switching, and optical Q-switches. 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 March 31, 2007 were \$3,541,000 as compared with total sales of \$3,663,000 for the same three months in 2006, a decrease of 3.3%. Sales of custom optical components in this quarter decreased by approximately 4.3% from the same period in the prior year, with a reduction in demand for UV filter crystals from a defense industry OEM customer. This was offset somewhat by an approximately 1% increase in sales of laser accessories. Sales of optical components remained strong to customers within the aerospace/defense and process control and metrology industry sectors. Shipments to two aerospace/defense industry customers in the first quarter represented 15.3% and 18.8% of total sales in the period, respectively. During fiscal year 2006 sales to two aerospace customers represented 13.0% and 13.6% of total revenues in the first quarter.

Product bookings for the quarter ended March 31, 2007 were \$4,960,000 as compared with \$2,271,000 for the same period last year, an increase of 118%. In this year's first quarter, order intake for optical components was especially strong for Laser Optics, while order intake at INRAD and MRC for optical components was moderate. Major OEM customer orders do not usually follow a strict seasonal trend, and major production releases from aerospace/defense industry customers usually occur once or twice per year at irregular intervals. In this year's first quarter, orders from four major OEM customers accounted for 67% of new orders. Of these, one large order for high precision crystal optical components was from a major defense industry OEM customer in the infra-red imaging systems sector, another was for precision X-ray monochrometers from a major multinational manufacturer of X-ray analytical process control and metrology equipment, another was for UV filter crystal components from a defense industry manufacturer of aircraft missile warning sensors and self-protection systems, while the fourth was for laser accessories and specialty laser frequency doubling crystals from a major manufacturer of commercial laser systems. In last year's first quarter, orders from three INRAD and MRC Optics OEM customers accounted in the aggregate for 56% of total new orders. One order was from a major defense industry OEM customer, on a new program, which represented 30% of total bookings for the quarter. Another order, representing 17% of new orders was from another defense industry OEM who issued a follow-on production release for proprietary INRAD filter crystal components used in their anti-aircraft missile warning systems, while the third was from an industrial factory automation sector customer.

Product backlog at March 31, 2007 was \$8,450,000 which compares with a backlog of \$6,484,000 at the same point in 2006 and a backlog of \$6,969,000 on December 31, 2006.

Based upon the backlog at the end of the first quarter, and related delivery schedules, management expects revenues to trend moderately higher in the second quarter.

## Cost of Goods Sold

For the three-month period ended March 31, 2007, the cost of goods sold as a percentage of product revenues was 61.0% as compared with 67.6% for the same

period last year. For the full year 2006, the actual cost of goods sold percentage was 67.4%.

Gross margin was 39.0% in the first quarter, compared with 32.4% in the first quarter of last year. Gross margin in 2006 was 32.6% for the full year. In dollar terms, first quarter cost of goods sold was \$2,159,000 compared with \$2,475,000 in the same period in 2006, down 12.8%. A part of this decrease is attributable to the 3.3% decrease in revenues. However, this reduction in cost of goods sold was primarily a result of improved operational productivity and related cost reduction, in this quarter, compared to the previous period. Work-in-process inventory levels increased in the period as production backlogs for the second quarter rose to record levels, positively affecting the cost of goods sold and gross margin.

#### **Selling, General and Administrative Expenses**

Selling, general and administrative expenses were \$857,000, or 24.2% of sales, in the first quarter of 2007 compared to \$873,000, or 23.8% in the same period in the prior year. This decrease in dollar costs reflects management's ongoing focus on tight control over costs and cash outflows.

#### **Operating Income**

The company realized operating income for the quarter ending March 31, 2007 of \$525,000, equal to 14.8% of sales, as compared with operating income of \$315,000, or 8.6% of sales, for the same period last year. As discussed above, the increase in income from operations, despite a 3.3% decrease in sales, was the result of improved margins resulting from increased productivity and improved operational efficiencies.

#### **Other Income and Expenses**

Interest expense-net in the first quarter of 2007 was \$75,000, as compared with \$113,000 in the first quarter of last year.

Interest expense-net decreased over prior periods due to the decrease in capital lease obligations for the comparative periods, and increased interest income realized on this year's higher cash balances.

#### **Net Income Applicable to Common Shareholders**

The company had net income applicable to common shareholders of \$435,000 for the period ending March 31, 2007, or \$0.06 per share basic, and \$0.04 per share diluted, as compared with net income applicable to common shareholders of \$202,000, or \$0.03 per share basic and \$0.02 per share diluted in the same period, last year.

#### **Liquidity and Capital Resources**

Net cash flow from operating activities was positive at \$287,000 in this year's first quarter, but was below prior years comparable with positive net cash flow from operations of \$419,000 in the same period last year. Cash flow from operations decreased from that in the first quarter of last year despite significantly higher net income primarily due to a greater deployment of cash into increased work-in-process inventory, and a higher liquidation of customer cash advances against product shipments during the comparable periods.

During the three month periods ended March 31, 2007, and March 31, 2006, working capital requirements were funded from cash generated by operations.

Management expects that cash flow from operations will provide adequate liquidity for the Company's operations throughout 2007.

Capital expenditures for the three months ended March 31, 2007 were \$30,000, compared to \$800,000 in the first quarter of 2006. Capital expenditures for all of 2006 were \$987,000. In the first quarter of 2007 these expenditures were primarily for replacement or refurbishment of capital equipment at the



end of its useful life, in addition to the acquisition of new computer hardware and engineering software.

In the first quarter of 2006, capital additions represented major expenditures for equipment required in the performance of certain specific contracts and to give the Company increased capability and a stronger competitive position in the manufacture of spherical and aspherical lenses.

On April 16, 2007, the Company called for the redemption of its Series A 10% Convertible Preferred Stock (the Series A ). On April 30, 2007, the Company received notice that Clarex Limited, the holder of all the shares of the Series A, elected to convert the 500 preferred shares into 500,000 shares of the Company's common stock, in accordance with the Series A Agreement.

Management expects to continue to deploy excess cash from time to time into repayment of debt.

Management also expects that it may from time to time attempt to raise investment capital and to make investments in capital acquisitions, both in equipment and acquisition of complementary lines of businesses, to pursue its objective of growth in shareholder value and to maintain a competitive edge in the markets that it serves.

In February 2006, a major shareholder and debt holder provided the Company with \$700,000 in financing to fund the acquisition of certain capital assets required for expanded capabilities to meet customer demand. The terms call for repayment of the Company's Promissory note in equal monthly installments, including interest & principal, commencing March 2006, until maturity in March 2013. The Note bears an annual interest rate of 6.75%.

In 2002, the Company received \$1,000,000 in proceeds from the issuance of a Subordinated Convertible Promissory Note. The note, originally due in January 2006, has been extended to December 31, 2008 and bears an interest rate of 6%. Interest accrues yearly and along with principal may be converted into Common Stock, (and/or securities convertible into common shares). The note is convertible into 1,000,000 Units consisting of 1,000,000 shares of Common Stock and Warrants to acquire 750,000 shares of Common Stock at a price of \$1.35 per share. The Holder of the Note is a related party to a major shareholder of the Company.

In June of 2003, the Company paid off existing debt with the proceeds of a \$1,700,000 Secured Promissory Note held by a major investor in the Company. The note was for a period of 36 months at an interest rate of 6% per annum. The Company's Board of Directors approved the issuance of 200,000 warrants to Clarex Limited, the lender, as a fee for the issuance of the Note. In 2004, the Company approved the issuance of 200,000 additional warrants to Clarex, as additional consideration in connection with the same transaction. The note was subsequently extended to December 31, 2008 without issuance of warrants or any other consideration. The warrants are exercisable at \$0.425 per share and \$1.08 per share, respectively, approximately a 20% discount to market, and expire in March 2008 and May 2008. The note is secured by all assets of the Company.

A Subordinated Convertible Promissory Note for \$1,500,000 originally due in January 2006, has been extended to December 31, 2008 and bears an interest rate of 6%. Interest accrues yearly and along with principal may be converted into Common Stock, and/or securities convertible into Common Stock. The note is convertible into 1,500,000 Units consisting of 1,500,000 shares of Common Stock and Warrants to acquire 1,125,000 shares of Common stock at a price of \$1.35 per share. The Holder of the Note is a major shareholder of the Company. The proceeds from the Note were used in the Company's acquisition program.

In 2004, the Company received \$1,000,000 in proceeds from the issuance of a Subordinated Convertible Promissory Note. The note bears an interest rate of 6% and was initially due on March 31, 2007, but its term has been extended to March 31, 2008. Interest accrues yearly and along with principal may be

converted into Common Stock, (and/or securities convertible into common shares). The note is convertible into 1,000,000 Units consisting of 1,000,000 shares of Common Stock and Warrants to acquire 750,000 shares of Common Stock at a price of \$1.35 per share. The note holder is a major shareholder of the Company.

**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 March 31, 2007. 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**

During the first quarter of 2007, our management, including the principal executive officer and principal financial officer evaluated our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities and Exchange Act of 1934) related to the recording, processing, summarization and reporting of information in the reports that we file with the SEC. These disclosure controls and procedures have been designed to ensure that material information relating to us, including our subsidiaries, is made known to our management, including these officers and that this information is recorded, processed, summarized, evaluated and reported, as applicable, within the time periods specified in the SEC's rules and forms. Due to inherent limitations of control systems, not all misstatements may be detected. Our controls and procedures can only provide reasonable, not absolute, assurance that the above objectives have been met.

Based upon their evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were effective to reasonably ensure that information required to be disclosed by us in the reports we file or submit under the Securities Exchange Act of 1934 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**

There were no 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 for the year ended December 31, 2006 which was filed with the Securities and Exchange Commission on March 30, 2007.

**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**

On May 5, 2004, the Board of Directors amended the By-laws of the Company to eliminate the age restriction for Directors. This information was omitted from the Company's previous filings with the Securities and Exchange Commission.

**ITEM 6. EXHIBITS**

3.1 By-laws

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.

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**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 and Secretary**

Date: May 14, 2007