

PHOTONIC PRODUCTS GROUP INC  
Form 10-Q  
November 15, 2010

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION  
13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended SEPTEMBER 30, 2010

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)
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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  The Registrant is not yet subject to this requirement.

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 <input type="checkbox"/>	Accelerated filer <input type="checkbox"/>	Non-accelerated filer <input type="checkbox"/>	Smaller reporting company <input checked="" type="checkbox"/>
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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

Common shares of stock outstanding as of November 15, 2010:

11,558,056 shares

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## PHOTONIC PRODUCTS GROUP, INC AND SUBSIDIARIES

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PHOTONIC PRODUCTS GROUP, INC AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2010 (Unaudited)	December 31, 2009 (Audited)
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 4,243,420	\$ 4,069,310
Accounts receivable (net of allowance for doubtful accounts of \$15,000 in 2010 and 2009)	1,484,612	1,927,672
Inventories, net	2,602,370	2,265,973
Other current assets	110,264	164,081
<b>Total current assets</b>	<b>8,440,666</b>	<b>8,427,036</b>
Plant and equipment:		
Plant and equipment, at cost	14,724,355	14,604,728
Less: Accumulated depreciation and amortization	(12,661,325)	(12,016,247)
<b>Total plant and equipment</b>	<b>2,063,030</b>	<b>2,588,481</b>
Precious Metals	157,443	157,443
Deferred Income Taxes	408,000	408,000
Goodwill	311,572	311,572
Intangible Assets, net	614,093	673,016
Other Assets	51,078	45,192
<b>Total Assets</b>	<b>\$ 12,045,882</b>	<b>\$ 12,610,740</b>
<b>Liabilities and Shareholders' Equity</b>		
Current Liabilities:		
Current portion of other long term notes	\$ 9,000	\$ 9,000
Accounts payable and accrued liabilities	2,228,427	1,632,650
Customer advances	114,418	346,429
Related party convertible notes payable due within one year	2,500,000	—
<b>Total current liabilities</b>	<b>4,851,845</b>	<b>1,988,079</b>
Related Party Convertible Notes Payable	—	2,500,000
Other Long Term Notes, net of current portion	338,185	344,946
<b>Total liabilities</b>	<b>5,190,030</b>	<b>4,833,025</b>
<b>Commitments</b>		
<b>Shareholders' Equity:</b>		
Common stock: \$.01 par value; 60,000,000 authorized shares; 11,562,656 shares issued at September 30, 2010 and 11,443,347 issued at December 31, 2009	115,626	114,433
Capital in excess of par value	17,355,938	17,073,871
Accumulated deficit	(10,600,762)	(9,395,639)
	6,870,802	7,792,665
Less - Common stock in treasury, at cost (4,600 shares)	(14,950)	(14,950)
<b>Total shareholders' equity</b>	<b>6,855,852</b>	<b>7,777,715</b>

Total Liabilities and Shareholders' Equity	\$ 12,045,882	\$ 12,610,740
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See Notes to Condensed Consolidated Financial Statements (Unaudited)

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

	Three Months Ended September		Nine Months Ended September	
	30, 2010	2009	30, 2010	2009
Total revenue	\$ 2,478,581	\$ 2,664,963	\$ 7,451,118	\$ 8,100,497
Cost and expenses:				
Cost of goods sold	1,983,903	2,058,433	6,160,234	6,693,182
Selling, general and administrative expenses	741,657	746,511	2,391,347	2,533,442
Goodwill impairment charge	—	1,558,074	—	1,558,074
	2,725,560	4,363,018	8,551,581	10,784,698
(Loss) from operations	(246,979)	(1,698,055)	(1,100,463)	(2,684,201)
Other expense:				
Interest expense—net	(34,776)	(32,275)	(104,660)	(96,907)
Gain on sale of precious metals	—	—	—	7,371
	(34,776)	(32,275)	(104,660)	(89,536)
Net (loss) before income taxes	(281,755)	(1,730,330)	(1,205,123)	(2,773,737)
Income tax provision	—	392,000	—	—
Net (loss)	\$ (281,755)	\$ (2,122,330)	\$ (1,205,123)	\$ (2,773,737)
Net (loss) per common share—basic and diluted	\$ (0.02)	\$ (0.19)	\$ (0.10)	\$ (0.25)
Weighted average shares outstanding—basic and diluted	11,558,056	11,404,247	11,512,335	11,311,574

See Notes to Condensed Consolidated Financial Statements (Unaudited)

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

	Nine Months Ended September 30,	
	2010	2009
<b>Cash flows from operating activities:</b>		
Net (loss)	\$ (1,205,123)	\$ (2,773,737)
<b>Adjustments to reconcile net loss to cash provided by operating activities:</b>		
Depreciation and amortization	707,462	753,711
401(k) common stock contribution	154,535	179,068
Goodwill impairment charge	—	1,558,074
Gain on sale of precious metals	—	(7,371)
Loss on disposal of fixed assets	944	—
Stock based compensation	121,464	86,433
<b>Changes in operating assets and liabilities:</b>		
Accounts receivable	443,060	1,093,609
Inventories, net	(336,397)	292,140
Other current assets	53,817	1,306
Other assets	(5,886)	34,106
Accounts payable and accrued liabilities	595,777	(424,755)
Customer advances	(232,011)	(341,087)
Total adjustments and changes	1,502,765	3,225,234
Net cash provided by operating activities	297,642	451,497
<b>Cash flows from investing activities:</b>		
Capital expenditures	(124,032)	(139,180)
Purchase of precious metals	—	(53,538)
Proceeds from redemption of certificates of deposit	—	800,000
Proceeds from sale of precious metals	—	16,317
Net cash (used in) provided by investing activities	(124,032)	623,599
<b>Cash flows from financing activities:</b>		
Redemption of restricted stock units	(1,239)	(1,861)
Proceeds from exercise of stock options	8,500	75,325
Proceeds from exercise of warrants	—	67,500
Principal payments of notes payable-other	(6,761)	(134,388)
Net cash provided by financing activities	500	6,576
Net increase in cash and cash equivalents	174,110	1,081,672
Cash and cash equivalents at beginning of period	4,069,310	2,672,087
Cash and cash equivalents at end of period	\$ 4,243,420	\$ 3,753,759
<b>Supplemental Disclosure of Cash Flow Information:</b>		
Interest paid	\$ 11,000	\$ 15,056

Income taxes (refund) paid	\$	(74,000)	\$	25,000
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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 in consolidation.

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, 2009.

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

September	
30,	December 31,
2010	2009
(in thousands)	

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Raw materials	\$	1,213	\$	1,066
Work in process, including manufactured parts and components		819		654
Finished goods		570		546
	\$	2,602	\$	2,266

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## Income Taxes

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

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.

At September 30, 2010, the Company had a total net deferred tax asset balance of \$3,141,000, an increase of \$284,000 from December 31, 2009. The Company has increased the valuation allowance to \$2,733,000 to fully offset the current period increase in the deferred tax asset.

As of September 30, 2010, the Company has recognized a portion of the net deferred tax assets in the amount of \$408,000 which the Company's management is reasonably assured will be fully utilized in future periods. The Company believes that the current year's losses were caused by the recent economic conditions. 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 that is consistent with the plans and estimates that management is using to manage the underlying business. The Company's valuation allowance as of September 30, 2010 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 may be reduced by a 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.

In the third quarter of 2009, due to the negative impact of the economic recession on the Company's profitability, the Company re-evaluated the likelihood that the benefit of deferred tax assets would be realized in future periods and accordingly, the Company increased its estimate of the valuation allowance against the deferred tax assets and recorded a deferred tax provision in the amount of \$392,000. This offset the net tax benefit recorded in the first six months of 2009 and reduced the net deferred tax asset to \$408,000.

## Net (Loss) Income per Common Share

The Company computes and presents net (loss) income per common share in accordance with FASB ASC Topic 260, "Earnings Per Share". Basic (loss) income per common share is computed by dividing net (loss) income by the weighted average number of common shares outstanding during the period. Diluted (loss) income per common share is computed by dividing net (loss) income 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 and nine months ended September 30, 2010 and 2009, the potential dilutive effect of all common equivalent shares outstanding have been excluded from the diluted computation because their effect is anti-dilutive. A total of 811,000 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 income per common share for the three and nine months ended September 30, 2010. For the three and nine months ended September 30, 2009, 1,043,000 stock options and grants, 1,935,000 warrants and 2,500,000 common shares issuable upon conversion

of outstanding convertible notes were excluded from the computation of diluted net income per common share.

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## Stock-Based Compensation

The Company accounts for stock-based compensation pursuant to FASB ASC Topic 505, "Share-Based Payment," which requires compensation costs related to share-based transactions, including employee stock options, to be recognized in the financial statements based on fair value.

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 January 2010, the FASB issued guidance to amend the disclosure requirements related to recurring and nonrecurring fair value measurements. The guidance requires new disclosures on the transfers of assets and liabilities between Level 1 (quoted prices in active market for identical assets or liabilities) and Level 2 (significant other observable inputs) of the fair value measurement hierarchy, including the reasons and timing of the transfers. Additionally, the guidance requires a roll forward of activities on purchases, sales, issuance and settlements of the assets and liabilities measured using Level 3 fair value measurements (significant observable inputs). This guidance is effective for the Company on or after January 1, 2010, except for the disclosure on the roll forward activities for Level 3 fair value measurements, which does not become effective until fiscal years beginning after December 15, 2010. Adoption of this new guidance is for disclosure purposes only and did not have a material effect on our consolidated financial position, results of operations or cash flows.

In April 2010, the Financial Accounting Standards Board (FASB) ratified a consensus of the FASB Emerging Issues Task Force that recognizes the milestone method as an acceptable revenue recognition method for substantive milestones in research or development arrangements. This consensus requires its provisions be met in order for an entity to recognize consideration that is contingent upon achievement of a substantive milestone as revenue in its entirety in the period in which the milestone is achieved. In addition, this consensus would require disclosure of certain information with respect to arrangements that contain milestones. This authoritative guidance was adopted by the Company on July 1, 2010 but did not have a material impact on our consolidated 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 September 30, 2010 and 2009 include stock-based compensation expense for stock option grants totaling \$29,766 and \$14,905, respectively. Such amounts have been included in the accompanying Consolidated Statements of Operations within cost of goods sold in the amount of \$10,830 (\$2,162 for 2009), and selling, general and administrative expenses in the amount of \$18,936 (\$12,743 for 2009).

The Company's results of operations for the nine months ended September 30, 2010 and 2009 include stock-based compensation expense for stock option grants totaling \$89,298 and \$50,275, respectively. Such amounts have been included in the accompanying Consolidated Statements of Operations within cost of goods sold in the amount of \$32,490 (\$6,098 for 2009), and selling, general and administrative expenses in the amount of \$56,808 (\$44,177 for 2009).

As of September 30, 2010 and 2009, there were \$230,138 and \$118,658 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 2.3 years and 2.75 years, respectively.

The following range of weighted-average assumptions were used to determine the fair value of stock option grants during the nine months ended September 30, 2010 and 2009, respectively:

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	Nine Months Ended	
	2010	2009
Expected Dividend yield	0.00%	0.00%
Expected Volatility	226 - 236%	180 - 218%
Risk-free interest rate	2.7 - 3.7%	2.5 - 3.2%
Expected term	8 -10 years	8 -10 years

b) Stock Option Activity

For the nine months ended September 30, 2010, there were 10,000 options granted with a weighted average estimated fair value of \$1.00 and a weighted average exercise price of \$1.00 which was equal to the closing market price on the date of the grants. The options have a term of 10 years and vest ratably over the first three years following the grant date.

The following table represents stock options granted, exercised, and forfeited during the nine month period ended September 30, 2010:

Stock Options	Number of Options	Weighted Average Exercise Price per Option	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Outstanding at January 1, 2010	1,215,723	\$ 1.46	3.5	\$ 161,000
Granted	10,000	1.00		
Exercised	(10,000)	.85		
Expired	(395,500)	2.16		
Forfeited	(16,147)	1.27		
Outstanding at September 30, 2010	804,076	\$ 1.14	5.7	\$ 80,295
Exercisable at September 30, 2010	543,952	\$ 1.12	4.0	\$ 80,295

The following table represents non-vested stock options granted, vested and forfeited for the nine months ended September 30, 2010.

Non-vested Options	Options	Weighted-Average Grant-Date Fair Value
Non-vested - January 1, 2010	300,728	\$ 1.21
Granted	10,000	\$ 1.00
Vested	(36,373)	\$ 1.65
Forfeited	(14,231)	\$ 1.06
Non-vested - September 30, 2010	260,124	\$ 1.16

The total fair value of options vested during the nine months ended September 30, 2010 and 2009 was \$60,000 and \$49,000, respectively.





## c) Restricted Stock Unit Awards

There were no grants of restricted stock units under this plan during the nine months ended September 30, 2010 and 2009.

Restricted stock unit awards generally vest over a three year period contingent on continued employment or service over the vesting period.

The Company's results of operations for the three months ended September 30, 2010 and 2009 include stock-based compensation expense for restricted stock unit grants totaling \$11,613 and \$8,938, respectively. Such amounts have been included in the accompanying Consolidated Statements of Operations within cost of goods sold in the amount of \$1,335 (\$1,333 for 2009), and selling, general and administrative expenses in the amount of \$10,278 (\$7,605 for 2009).

The Company's results of operations for the nine months ended September 30, 2010 and 2009 include stock-based compensation expense for restricted stock unit grants totaling \$32,166 and \$36,158, respectively. Such amounts have been included in the accompanying Consolidated Statements of Operations within cost of goods sold in the amount of \$4,005 (\$4,002 for 2009), and selling, general and administrative expenses in the amount of \$28,161 (\$32,156 for 2009).

A summary of the Company's non-vested restricted stock units at September 30, 2010 is presented below:

	Restricted Stock Units	Weighted-Average Grant-Date Fair Value
Non-vested - January 1, 2010	17,996	\$ 3.68
Granted	—	—
Vested	(6,998)	\$ 3.59
Forfeited	(4,000)	\$ 4.00
Non-vested – September 30, 2010	6,998	\$ 3.59

## NOTE 3- STOCKHOLDERS' EQUITY

During the nine months ended September 30, 2010, the Company issued 103,403 common shares to the PPGI 401(k) plan as a match to employee contributions made during 2009. In addition, 10,000 common shares were issued for proceeds of \$8,500 in connection with a stock option exercise and 5,906 shares of common stock were issued, net of vested shares tendered to cover withholding taxes, on the vesting of employee stock grants during the nine months ended September 30, 2010.

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 Annual 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 "anticipate", "believe", "continue", "estimate", "expect", "may", "intend", "plan:", "project", and "wi opposites 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, 2009, as filed with the Securities and Exchange Commission on March 31, 2010. 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, 2009. 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, 2009.

Results of Operations

Photonic Products Group, Inc.'s business includes two general 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). The Company operates manufacturing facilities in Florida and New Jersey.

## Revenue

Sales for the three months ended September 30, 2010 were \$2,479,000 compared with \$2,665,000 in the third quarter of 2009, down 7.0%. Sales for the nine months ended September 30, 2010 were \$7,451,000 compared with \$8,100,000 for the nine months ended September 30, 2009, down 8.0%.

Overall, the Company's sales continue to reflect reduced spending by the defense/aerospace customers we serve and the lingering effects of the economic recession on many of our commercial customers.

Sales of custom optical components in the third quarter and year to date declined by approximately 8.4% and 15.9%, respectively, compared to the same periods in 2009, reflecting lower sales activity of this product segment across all three business brands. Offsetting this, sales of laser accessories in the third quarter and year to date increased by 4.3% and 26.4%, respectively, compared to the same periods in the prior year, as demand for our laser systems and related components increased.

The Company's sales base has been historically comprised of a small number of large volume accounts. Sales volumes for each account tend to fluctuate from quarter to quarter as orders are scheduled for delivery. In order to diversify our customer base and mitigate the impact of these fluctuations, the Company's sales and marketing efforts have been expanded to develop new markets and products. The Company's efforts in this area will take some time to achieve significant results but to-date progress has been shown with several new international and domestic accounts.

Orders for the third quarter were \$4.63 million compared to \$1.55 million last year. This was the Company's highest level of new orders since the first quarter of 2008. Total orders for the nine months ended September 30, 2010 were \$8.87 million compared to \$6.35 million for the same nine month period last year. The Company also saw its book to bill ratio increase to 1.19 to 1 in the first nine months of 2010 from a book to bill ratio of 0.78 to 1 last year. The book to bill ratio is defined by the Company as its ratio of new orders to sales in a period.

Product backlog was \$5.6 million at September 30, 2010 compared to backlog of \$4.3 million at September 30, 2009.

## Cost of Goods Sold

For the three months ended September 30, 2010, cost of goods sold was \$1,984,000 or 80.0% of sales compared to \$2,058,000 or 77.2% of sales, for the same period last year. For the nine months ended September 30, 2010, cost of goods sold was \$6,160,000 or 82.7% of sales compared to \$6,693,000 or 82.6% for the nine months ended September 30, 2009.

In the three and nine months ended September 30, 2010, manufacturing wages and salaries and related fringe benefits fell by 8.0% and 10.5% compared with the same period in 2009 mainly as a result of the Company's work force reductions that were initiated at the end of the first quarter of 2009, as well as, additional staff reductions in the second and third quarters of 2009.

Material costs, as a percentage of sales, increased slightly due to the shift in product sales mix in the first nine months of 2010 compared to 2009 although the purchase price of many components and supplies remained relatively stable year over year.

Gross margin in the third quarter of 2010 was \$495,000 or 20.0%, compared with \$607,000 or 22.8% in the comparable period of 2009, reflecting the factors discussed above. For the nine months ended September 30, 2010, the gross margin was \$1,291,000 or 17.3%, compared with \$1,407,000 or 17.4% for the nine months ended September 30, 2009.

Selling, General and Administrative Expenses

Selling, general and administrative expenses (“SG&A” expenses) in the three months ended September 30, 2010 were \$742,000 or 29.9% of sales compared to \$747,000 or 28.0% of sales for the three months ended September 30, 2009. Despite the slight decrease in the dollar amount of SG&A expenses, the expenses increased as a percentage of sales as the sales decline outpaced the expense savings during the current quarter compared to the same quarter in the prior year.

For the nine months ended September 30, 2010, SG&A expenses were \$2,391,000 or 32.1% of sales compared to \$2,533,000 or 31.3% for the nine months ended September 30, 2009. This represents a decrease of \$142,000 or 5.6% which is comprised mainly of a decrease in SG&A salaries and wages and fringe benefits expense of \$93,000 reflecting personnel reductions implemented in the first quarter of 2009 and additional reductions in the second quarter of 2009.

#### Operating Loss

The Company had an operating loss of \$247,000 in the three months ended September 30, 2010 and \$1,100,000 for the nine months ended September 30, 2010. During the three months ended September 30, 2009, the Company recorded a non-cash charge for the impairment of goodwill of \$1,558,000. Excluding the charge for goodwill impairment, the Company had an operating loss of \$140,000 for the three months ended September 30, 2010 and \$1,126,000 for the nine months ended September 30, 2010. Despite an 8% reduction in sales in the nine months ended 2010 compared to the same period last year, the Company's operating loss was positively affected by savings in manufacturing and SG&A salaries, wages and fringe benefits, as discussed above, and was slightly less than the comparable period last year.

#### Other Income and Expense

For the three months ended September 30, 2010, net interest expense was \$35,000, a slight increase from \$32,000 in the same period last year. For the nine months ended September 30, 2010, net interest expense was \$105,000, versus \$97,000 in the comparable period last year. The increase was primarily the result of a decrease in offsetting interest earned, as lower bank interest rates were slightly offset by higher cash balances in 2010 compared to the third quarter and nine months ended September 30, 2009.

#### Income Taxes

For the three and nine months ended September 30, 2010, the Company did not record a provision for current state tax or federal alternative minimum tax as the Company incurred a loss for both income tax and financial reporting purposes.

In the three months ended September 30, 2009, the Company re-evaluated the likelihood that the benefit of its deferred tax assets would be realized in future periods and accordingly, the Company increased its estimate of the valuation allowance against the deferred tax assets and recorded a deferred tax provision of \$392,000.

For the nine months ended September 30, 2009, the Company did not record a provision for current state or federal alternative minimum tax as the Company incurred a loss for both income tax and financial reporting purposes.

#### Net Loss

The Company had a net loss of \$282,000 and \$1,205,000, respectively, for the three and nine months ended September 30, 2010 compared with \$2,122,000 and \$2,774,000 for the three and nine months ended September 30, 2009, which included a non-cash charge of \$1,558,000 for goodwill impairment. Excluding the non-cash charge for goodwill in 2009, the net losses incurred in 2010 improved despite lower sales volumes mainly as a result of the positive effect of lower manufacturing labor costs on profit margins and the impact of SG&A cost reductions, 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 uses of cash in the past two years have 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 cash requirements for principal and interest payments on our outstanding indebtedness, working capital, new product development, capital expenditures, contractual obligations and other operating needs over the next twelve months.

The following table summarizes the net cash provided and used by operating, investing and financing activities for the nine months ended September 30, 2010 and 2009:

	Nine Months Ended September 30,	
	2010	2009
	(In thousands)	
Net cash provided by operating activities	\$ 297	\$ 451
Net cash (used in) provided by investing activities	(124)	624
Net cash provided by in financing activities	1	7
Net increase in cash and cash equivalents	\$ 174	\$ 1,082

Net cash flow provided by operating activities was \$297,000 for the nine months ended September 30, 2010, compared with net cash flow provided by operating activities of \$451,000 in the same period last year. The decrease in operating cash flows was primarily due to changes in working capital levels related to lower reductions in accounts payable and customer advances, offset by lower reductions in accounts receivable levels and an increase in inventories, as compared to the comparable period last year.

In the nine months ended September 30, 2010, accounts payable balances increased which provided \$596,000 of cash flow in 2010 compared to a decrease in accounts payable balances in the comparable period in 2009 which was a use of cash in the amount of \$425,000. The increase in 2010 primarily reflects an increase in purchasing activity required as a result of an increase in bookings while the decrease in 2009 primarily reflected the decrease in purchasing activity in 2009 due to a decline in sales volume in 2009 compared to 2008.

Inventory levels increased by \$336,000 to \$2,602,000 at September 30, 2010 compared to a decrease of \$292,000 in the nine month period ended September 30, 2009. The increase in inventory was primarily related to higher production levels required to meet the increase an increase in new orders in 2010.

In the first nine months of 2010, reductions in accounts receivable provided \$443,000 of cash flow. Accounts receivable balances fell from \$1,928,000 at December 31, 2009 to \$1,485,000 at September 30, 2010. While accounts receivable balances did continue to decrease in 2010, they did not decrease at the same rate as compared to the \$1,094,000 decrease in accounts receivable in the comparable period in 2009. The decrease in 2009 was primarily the result of the decline in sales volume in 2009 compared to 2008.

Customer advances decreased by \$232,000 to \$114,000 in the first nine months of 2010. Customer advances vary with the timing of orders received from customers. In the comparable period in 2009, customer advances decreased by \$341,000 to \$346,000.

A Subordinated Convertible Promissory Note for \$1,000,000, bearing an interest rate of 6% per annum and issued to Clarex Limited is due on April 1, 2011. 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 which allow the holder, at their option, to acquire an additional 750,000 shares of common stock at a price of \$1.35 per share. The warrants have an expiration date of April 1, 2014.

A second Subordinated Convertible Promissory Note for \$1,500,000, bearing an interest rate of 6% per annum also matures on April 1, 2011. 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 additional shares of common stock at a price of \$1.35 per share up to April 1, 2014, at the option of the holder. The holder of the note is a major shareholder of the Company.

The total amount of \$2,500,000 in Subordinated Convertible Promissory Notes due on April 1, 2011 have been reclassified from long term debt to current liabilities on the balance sheet at September 30, 2010.

Capital expenditures for the nine months ended September 30, 2010 were \$124,000, down from \$139,000 last year. Management continued its review program for 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 nine months ended September 30, 2009, the Company redeemed \$800,000 of certificates of deposit, and purchased precious metal manufacturing tools for \$53,000 offset by the receipt of \$16,000 for similar precious metal tools that were sold as part of the purchase.

Net cash provided by financing activities during the first nine months of 2010 totaled \$1,000 and consisted of principal payments of \$6,000 on other long term notes offset by the proceeds from the exercise of stock options in the amount of \$7,000. In the first nine months of 2009, net cash provided by financing activities was \$7,000 and consisted of principal payments of \$134,000 on other long term notes, offset by the proceeds from the exercise of stock options and warrants in the amount of \$141,000.

The Company had a net increase in cash and cash equivalents of \$174,000 in the nine months ended September 30, 2010 compared with an increase of \$1,082,000 in the corresponding period last year.

Cash and cash equivalents at September 30, 2010 were \$4,243,000 compared to \$4,069,000 at December 31, 2009.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not Applicable

### 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 September 30, 2010 (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.

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 and Secretary

Date: November 15, 2010