STEPHAN CO
Form 10-Q
November 13, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d)
of the Securities Exchange Act of 1934

For the Quarterly Period Ended: September 30, 2006

Commission File No. 1-4436

THE STEPHAN CO.
(Exact Name of Registrant as Specified in its Charter)

Florida	59-0676812
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

1850 West McNab Road, Fort Lauderdale, Florida	33309
(Address of Principal Executive Offices)	(Zip Code)

Registrant's Telephone Number, including Area Code: (954) 971-0600

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.
YES X   NO

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).
Large accelerated filer[ ] Accelerated filer[ ] Non-accelerated filer[X]

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act)
YES   NO X

Approximate number of shares of Common Stock outstanding
as of November 1, 2006:

4,389,805

THE STEPHAN CO. AND SUBSIDIARIES
QUARTERLY REPORT PURSUANT TO SECTION 13
OF THE SECURITIES EXCHANGE ACT OF 1934
SEPTEMBER 30, 2006

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THE STEPHAN CO. AND SUBSIDIARIES
QUARTERLY REPORT PURSUANT TO SECTION 13
OF THE SECURITIES EXCHANGE ACT OF 1934
SEPTEMBER 30, 2006

CAUTIONARY STATEMENT FOR PURPOSES OF THE SAFE HARBOR
PROVISIONS OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

This quarterly report contains certain "forward-looking" statements. The Stephan Co. ("Stephan" or the "Company") desires to take advantage of the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995 and is including this statement for the express purpose of availing itself of the protections of such safe harbor with respect to all such forward-looking statements. Such forward-looking statements involve risks, uncertainties and other factors which may cause the actual results, condition (financial or otherwise), performance, trends or achievements of the Company and its subsidiaries to be materially different from any results, condition, performance, trends or achievements projected, anticipated or implied by such forward-looking statements.

Words such as "projects," "believe," "anticipates," "estimate," "plans," "expect," "intends," and similar words and expressions are intended to identify forward-looking statements and are based on our current expectations, assumptions, and estimates about us and our industry. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances are forward-looking statements. Although we believe that such forward-looking statements are reasonable, we cannot assure you that such expectations will prove to be correct.

Our actual results could differ materially from those anticipated in such forward-looking statements as a result of several factors, risks and uncertainties. These factors, risks and uncertainties include, without limitation, our ability to satisfactorily address any material weaknesses in our financial controls; general economic and business conditions; competition; the relative success of our operating initiatives; our development and operating costs; our advertising and promotional efforts; brand awareness for our product offerings; the existence or absence of adverse publicity; acceptance of any new product offerings; changing trends in customer tastes; the success of any multi-branding efforts; changes in our business strategy or development plans; the quality of our management team; costs and expenses incurred by us in pursuing strategic alternatives; the availability, terms and deployment of capital; the business abilities and judgment of our personnel; the availability of qualified personnel; our labor and employee benefit costs; the availability and cost of raw materials and supplies; changes in or newly-adopted accounting principles; changes in, or our failure to comply with, applicable laws and regulations; changes in our product mix and associated gross profit margins; as well as management's response to these factors, and other factors that may be more fully described in the Company's literature, press releases and publicly-

filed documents with the Securities and Exchange Commission. You are urged to carefully review and consider these disclosures, which describe certain factors that affect our business.

We do not undertake, subject to applicable law, any obligation to publicly release the results of any revisions, which may be made to any forward-looking statements to reflect events or circumstances occurring after the date of such statements or to reflect the occurrence of anticipated or unanticipated events. Therefore, we caution each reader of this report to carefully consider the specific factors and qualifications discussed herein with respect to such forward-looking statements, as such factors and qualifications could affect our ability to achieve our objectives and may cause actual results to differ materially from those projected, anticipated or implied herein.

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

THE STEPHAN CO. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

ASSETS

	September 30, 2006	December 31, 2005

CURRENT ASSETS		
Cash and cash equivalents	$ 6,231,566	$ 5,602,762
Restricted cash	1,112,074	3,335,557
Accounts receivable, net	2,292,675	1,431,650
Inventories	6,096,707	6,148,267
Income taxes receivable	-	22,893
Prepaid expenses and other current assets	389,958	311,905
TOTAL CURRENT ASSETS	16,122,980	16,853,034
RESTRICTED CASH	1,387,500	-
PROPERTY, PLANT AND EQUIPMENT, net	1,612,243	1,682,951
GOODWILL, net	4,013,458	4,013,458
TRADEMARKS, net	8,364,809	8,364,809
DEFERRED ACQUISITION COSTS, net	92,667	142,185
OTHER ASSETS, net	1,371,027	1,721,169
TOTAL ASSETS	$ 32,964,684	$ 32,777,606

See notes to unaudited condensed consolidated financial statements

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THE STEPHAN CO. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

LIABILITIES AND STOCKHOLDERS' EQUITY

	September 30, 2006	December 31, 2005
CURRENT LIABILITIES		
Accounts payable and accrued expenses	$ 2,189,538	$ 2,002,728
Current portion of long-term debt	1,110,000	3,237,500
Income taxes payable	43,600	-

TOTAL CURRENT LIABILITIES	3,343,138	5,240,228
DEFERRED INCOME TAXES, net	1,656,823	1,343,257
LONG-TERM DEBT, less current maturities	1,387,500	-
TOTAL LIABILITIES	6,387,461	6,583,485
COMMITMENTS AND CONTINGENCIES (NOTE 3)		
STOCKHOLDERS' EQUITY		
Common stock, $.01 par value	43,898	43,898
Additional paid in capital	17,623,735	17,556,731
Retained earnings	8,909,590	8,593,492
TOTAL STOCKHOLDERS' EQUITY	26,577,223	26,194,121
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 32,964,684	$ 32,777,606

See notes to unaudited condensed consolidated financial statements

THE STEPHAN CO. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	Nine Months Ended September 30,	
	2006	2005
NET SALES	$ 17,054,155	$ 17,141,001
COST OF GOODS SOLD	9,910,822	10,437,736
GROSS PROFIT	7,143,333	6,703,265
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	6,231,099	6,712,074
OPERATING INCOME/(LOSS)	912,234	(8,809)
OTHER INCOME(EXPENSE)		
Interest income	155,312	86,061
Interest expense	(110,580)	(74,122)

Other income, net	37,500	37,500
INCOME BEFORE INCOME TAXES	994,466	40,630
INCOME TAX EXPENSE	414,979	31,884
NET INCOME	$ 579,487	$ 8,746
BASIC AND DILUTED EARNINGS PER SHARE	$ .13	$ .00
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING	4,391,052	4,401,454

See notes to unaudited condensed consolidated financial statements

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THE STEPHAN CO. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended September 30,	
	2006	2005
NET SALES	$ 6,097,238	$ 6,567,510
COST OF GOODS SOLD	3,525,412	4,242,746
GROSS PROFIT	2,571,826	2,324,764
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	1,945,022	2,214,012
OPERATING INCOME	626,804	110,752
OTHER INCOME(EXPENSE)		
Interest income	48,919	34,567
Interest expense	(42,604)	(20,925)
Other income, net	12,500	12,500

INCOME BEFORE INCOME TAXES	645,619	136,894
INCOME TAX EXPENSE	279,367	43,038
NET INCOME	$ 366,252	$ 93,856
BASIC AND DILUTED EARNINGS PER SHARE	$ .08	$ .02
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING	4,391,052	4,401,454

See notes to unaudited condensed consolidated financial statements

THE STEPHAN CO. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine Months Ended September 30,	
	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 579,487	$ 8,746
Adjustments to reconcile net income to cash flows provided by operating activities:		
Depreciation	108,931	108,302
Stock option compensation	67,004	-
Amortization of intangible assets	49,518	55,711
Write-down of inventories	-	60,000
Deferred income tax provision	313,566	3,948
Provision for doubtful accounts	55,774	24,414
Changes in operating assets and liabilities:		
Accounts receivable	(916,799)	(579,162)
Inventories	51,560	370,470
Income taxes receivable/payable	66,493	(25,020)
Prepaid expenses and other current assets	(78,053)	87,768

Other assets	350,142	146,712
Accounts payable and accrued expenses	186,810	422,445
Total adjustments	254,946	675,588
Net cash flows provided by operating activities	834,433	684,334

See notes to unaudited condensed consolidated financial statements

THE STEPHAN CO. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine Months Ended September 30,	
	2006	2005
CASH FLOWS FROM INVESTING ACTIVITIES:		
Change in restricted cash	835,983	929,945
Purchase of property, plant and equipment	(38,223)	(179,784)
Net cash flows provided by investing activities	797,760	750,161
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayments of long-term debt	(740,000)	(832,500)
Dividends paid	(263,389)	(263,390)
Net cash flows used in financing activities	(1,003,389)	(1,095,890)
INCREASE IN CASH AND CASH EQUIVALENTS	628,804	338,605
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	5,602,762	4,402,463
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 6,231,566	$ 4,741,068

Supplemental Disclosures of
Cash Flow Information:

Interest paid	$ 32,641	$ 45,387
Income taxes paid	$ 35,178	$ 45,771

See notes to unaudited condensed consolidated financial statements

THE STEPHAN CO. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
QUARTERS ENDED SEPTEMBER 30, 2006 AND 2005

NOTE 1: NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

NATURE OF OPERATIONS: The Stephan Company (the "Company") is engaged in the manufacture, sale, and distribution of hair and personal care grooming products principally throughout the United States. The Company has allocated substantially all of its business into three segments, which include professional hair care products and distribution, retail personal care products and manufacturing.

BASIS OF PRESENTATION: In the opinion of management, all adjustments (consisting only of normal accruals) necessary for a fair presentation of the Company's financial position and results of operations are reflected in these unaudited interim financial statements.

The results of operations for the three and nine month periods ended September 30, 2006 is not necessarily indicative of the results to be achieved for the year ending December 31, 2006. The December 31, 2005 condensed consolidated balance sheet was derived from the audited consolidated financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America ("generally accepted accounting principles"). These interim financial statements should be read in conjunction with the audited consolidated financial statements and accompanying notes appearing in the Company's Annual Report on Form 10-K for the year ended December 31, 2005, previously filed with the Securities and Exchange Commission.

USE OF ESTIMATES: The preparation of consolidated financial statements in conformity with generally accepted accounting principles 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 consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

CASH AND CASH EQUIVALENTS: Cash and cash equivalents include cash, money market investment accounts and short-term instruments having maturities of 90 days or less when acquired. The Company maintains cash deposits at certain financial institutions in amounts in excess of the federally insured limit. Cash and cash equivalents held in interest-bearing accounts as of September 30, 2006 and December 31, 2005 were approximately $5,812,000 and $5,095,000, respectively.

INVENTORIES: Inventories are stated at the lower of cost (determined on a first-in, first-out basis) or market, and are as follows:

NOTE 1: NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

	September 30, 2006	December 31, 2005
Raw materials	$ 1,490,079	$ 1,692,277
Packaging and components	2,189,540	2,238,763
Work in progress	530,170	454,217
Finished goods	3,177,534	3,402,742
	7,387,323	7,787,999
Less: Amount included in other assets	(1,290,616)	(1,639,732)
	$ 6,096,707	$ 6,148,267

Raw materials include surfactants, chemicals and fragrances used in the production process. Packaging materials include cartons, inner sleeves and boxes used in the actual product, as well as outer boxes and cartons used for shipping purposes. Components are the actual bottles or containers (plastic or glass), jars, caps, pumps and similar materials that become part of the finished product. Finished goods include hair dryers, electric clippers, lather machines, scissors and salon furniture.

Included in other assets is inventory not anticipated to be utilized within one year and is comprised primarily of packaging, components and finished goods. The Company reduces the carrying value of inventory to provide for these slow moving goods that includes the estimated costs of disposal of inventory that may ultimately become unusable or obsolete.

BASIC AND DILUTED EARNINGS PER SHARE: Basic and diluted earnings per share are computed by dividing net income by the weighted average number of shares of common stock outstanding. The weighted average number of shares outstanding was 4,391,052 and 4,401,454, respectively, for both the nine-month and three-month periods ended September 30, 2006 and 2005. For the nine months ended September 30, 2006 and 2005, the Company had 396,178 and 351,240 outstanding stock options, respectively, a significant portion of which were anti-dilutive. The inclusion of dilutive stock options in the calculation of earnings per share did not have any impact on the earnings per share for the three month period ended September 30, 2006.

STOCK-BASED COMPENSATION: Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised), "Share-Based Payment" ("FAS 123R"), and chose to utilize the modified prospective transition method. Under this method, compensation costs

THE STEPHAN CO. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
QUARTERS ENDED SEPTEMBER 30, 2006 AND 2005

NOTE 1: NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

recognized at September 30, 2006 relate to the estimated fair value at the grant date of 75,310 stock options granted subsequent to January 1, 2006 in accordance with FAS 123R. Prior to the adoption of FAS 123R the Company accounted for stock options in accordance with APB Opinion No. 25, "Accounting for Stock Issued to Employees," and recognized no compensation expense in net income for stock options granted and has elected the disclosure only provisions of FAS 123. In accordance with the provisions of FAS 123R, options granted prior to January 1, 2006 have not been restated to reflect the adoption of FAS 123R. The required services for awards prior to January 1, 2006 had been rendered prior to December 31, 2005.

As a result of adopting FAS 123R on January 1, 2006, the Company's net income for the nine and three month periods ended September 30, 2006 was reduced due to the Company's recognition of approximately $67,000 and $25,000, respectively, of compensation expense (included in Selling, General and Administrative Expenses) in the periods that stock options were granted. The impact on basic and diluted earnings per share for the nine months and quarter ended September 30, 2006 was not material and the per share earnings remained at $.13 and $.08, respectively. For the nine months and quarter ended September 30, 2005, no compensation expense was recorded for options granted in the period, as indicated above. The Company has used the Black-Scholes option pricing model to estimate the fair value of stock options using the following assumptions as at September 30, 2006:

Life expectancy - Key Employee	10 years
Life expectancy - Outside Director	5 years
Risk-free interest rate	5.2%
Expected volatility	61.1%
Dividends per share	2.1%
Weighted average fair value at grant date	$1.88

The above assumptions are based on a number of factors as follows: (i) expected volatility was determined using the historical volatility of the Company's stock price, (ii) the expected term of the options is based on the period of time that the options granted are expected to be outstanding, and (iii) the risk free rate is the U.S. Treasury rate effective at the time of grant for the duration of the options granted. Compensation cost is recognized on a straight-line basis over the vesting period.

NOTE 1: NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

NEW FINANCIAL ACCOUNTING STANDARDS: In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3", effective for accounting changes and corrections of errors made in fiscal year 2006 and beyond. In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 140", effective for events occurring after the first fiscal year that begins after September 15, 2006. In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140", also effective for the first fiscal year that begins after September 15, 2006. In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements", effective for financial statements issued for fiscal years beginning after November 15, 2007. SFAS No. 157 defines fair value, establishes a framework for measuring fair value and expands required disclosures in connection therewith. The effect of these statements on the Company's consolidated financial statements will be determined based upon the nature and significance of future events, if any, that would be subject to these statements.

In July 2006 the FASB issued FASB Interpretation No. 48, ("FIN 48") "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109". FIN 48 requires that we recognize in our financial statements the impact of a tax position taken or expected to be taken in a tax return, provided that that position is more likely than not of being sustained on audit. FIN 48 is effective for fiscal years beginning after December 15, 2006. We do not anticipate that FIN 48 will have any adverse effect on our financial statements.

NOTE 2: SEGMENT INFORMATION

The Company has identified three reportable operating segments based upon the manner in which its management evaluates its business. These segments are Professional Hair Care Products and Distribution ("Professional"), Retail Personal Care Products ("Retail") and "Manufacturing". The Professional segment has a customer base consisting generally of distributors that purchase the Company's hair products and beauty and barber supplies for sale to salons and barbershops. The customer base for the Retail segment consists of mass merchandisers, chain drug stores and supermarkets that sell products to end-users. The Manufacturing segment manufactures products for different subsidiaries of the Company and manufactures private label brands for customers.

The Company conducts operations principally in the United States and sales to international customers are not material to its consolidated net

NOTE 2: SEGMENT INFORMATION (continued)

sales. Income/(Loss) Before Income Taxes as shown below reflects an allocation of corporate overhead expenses (based upon sales) incurred by the Manufacturing segment. The following tables, in thousands, summarize Net Sales and Income/(Loss) Before Income Taxes by reportable segment:

	NET SALES		NET SALES	
	Nine Months Ended Sept. 30,		Three Months Ended Sept. 30,	
	2006	2005	2006	2005
Professional	$12,906	$13,377	$ 4,698	$ 5,065
Retail	3,279	3,221	1,111	1,269
Manufacturing	3,505	4,058	1,181	1,642
Total	19,690	20,656	6,990	7,976
Intercompany Manufacturing	(2,636)	(3,515)	(893)	(1,408)
Consolidated	$17,054	$17,141	$ 6,097	$ 6,568

	INCOME/(LOSS) BEFORE INCOME TAXES		INCOME/(LOSS) BEFORE INCOME TAXES	
	Nine Months Ended Sept. 30,		Three Months Ended Sept. 30,	
	2006	2005	2006	2005
Professional	$ 693	$ 702	$ 384	$ 246
Retail	398	(25)	301	(12)
Manufacturing	(97)	(636)	(39)	(97)
Consolidated	$ 994	$ 41	$ 646	$ 137

NOTE 3: LONG-TERM DEBT

On September 26, 2006, the Company finalized a recasting of the

Wachovia Bank balloon payment due in August 2006. Under the terms of the loan modification agreement, the $2,497,500 that was due will continue to be paid in installment payments of $92,500, plus interest, monthly until the obligation is satisfied in January 2009. The interest rate remained the same, at 50 basis points above the rate of interest paid on the cash collateral. In connection with this modification, $1,387,500 of restricted cash has been reclassified to long-term as of September 30, 2006.

NOTE 4: COMMITMENTS AND CONTINGENCIES

The Company is involved in litigation matters arising in the ordinary course of business. It is the opinion of management that none of these matters, at September 30, 2006, would likely, if adversely determined, have a material adverse effect on the Company's financial position, results of operations or cash flows. Additionally, there has been no material change in the status of any other pending litigation since the Company's filing of its Annual Report on Form 10-K with the Securities and Exchange Commission for the year ended December 31, 2005.

THE STEPHAN CO. AND SUBSIDIARIES
QUARTERLY REPORT PURSUANT TO SECTION 13
OF THE SECURITIES EXCHANGE ACT OF 1934
SEPTEMBER 30, 2006 AND 2005

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

RESULTS OF OPERATIONS

Nine months ended September 30, 2006:

For the nine months ended September 30, 2006, net sales were $17,054,000, compared to $17,141,000 achieved in the corresponding nine-month period of 2005. The decrease in net sales was primarily a result of lower Professional sales in the third quarter of 2006. Gross profit for the nine months ended September 30, 2006 was $7,143,000, compared to gross profit of $6,703,000 achieved for the corresponding nine-month period in 2005. The increase in gross profit was the result of an overall change in the sales mix, especially in the third quarter of 2006. An increase in private label manufacturing and sales of certain retail brands, coupled with a decline in Professional hard goods sales had the effect of increasing our gross profit for both the three and nine month periods ended September 30, 2006. The overall gross profit for the nine months ended September 30, 2006 was 41.9% as compared to 39.1% for the nine months ended September 30, 2005.

Selling, general and administrative ("SGA") expenses for the nine months ended September 30, 2006 decreased by $481,000, to $6,231,000, when compared to the corresponding 2005 nine-month period total of $6,712,000. This decrease can be attributed to a decline in rent expense as warehouse facilities were consolidated and/or reduced, as well as a decline in professional fees.

Interest expense for the nine months ended September 30, 2006 was $111,000, an increase of approximately $37,000 from the $74,000 incurred in the corresponding period of 2005. For the nine months ended September 30, 2006, we accrued $78,000 in interest expense related to a previously disclosed arbitration award, more than offsetting any decline in interest expense on our bank debt. While our management believes we may ultimately prevail and/or settle for an amount substantially below the amount already accrued, our management continues to accrue interest on the entire obligation because it cannot predict the outcome of the litigation. Interest income of $155,000 for the nine months ended September 30, 2006 was higher than the $86,000 earned in the corresponding nine months of 2005 due to an increase in invested cash and the overall increase in interest rates. Other income includes royalty fees received from the licensing of our Frances Denney products.

Net income for the nine-month period ended September 30, 2006 was $579,000, compared to net income of $9,000 for the nine months ended September 30, 2005. An increase in gross profit and a reduction in SGA

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

expenses all contributed to income from operations of $912,000 for the nine months ended September 30, 2006, compared to a loss from operations of $9,000 for the comparable period in 2005. Income taxes for the nine months ended September 30, 2006 were $415,000, comprised of a net current state income tax provision of $102,000 and a deferred Federal income tax provision of $313,000.

Basic and diluted earnings per share was $0.13 for the nine months ended September 30, 2006, compared to $0.00 for the nine months ended

September 30, 2005, based on a weighted average number of shares outstanding of 4,391,052 and 4,401,454, respectively.

Three months ended September 30, 2006:

For the three months ended September 30, 2006, net sales were $6,097,000, compared to $6,568,000 for the three months ended September 30, 2005, a decrease of $471,000. Gross profit for the three months ended September 30, 2006 was $2,572,000, compared to gross profit of $2,325,000 achieved for the corresponding three-month period in 2005. As indicated above, similarly to the nine-month period ended September 30, 2006, the increase in gross profit was the result of an overall change in the sales mix. The gross profit margin for the three months ended September 30, 2006 was 42.2% as compared to 35.4% for the three months ended September 30, 2005.

SGA expenses for the three months ended September 30, 2006 decreased by $269,000, from $2,214,000 to $1,945,000, when compared to the corresponding three-month period of 2005.

Interest income for the three-month period ended September 30, 2006 was $49,000, an increase of approximately $14,000 when compared to $35,000 earned in the corresponding three-month period of 2005, primarily as a result of rising interest rates.

The income tax expense for the three months ended September 30, 2006 was $279,000 compared to $43,000 for the three-month period ended September 30, 2005. For the three months ended September 30, 2006, net income was $366,000 compared to $94,000 for the corresponding period in 2005. Basic and diluted earnings per share was $0.08 for the three months ended September 30, 2006 compared to $0.02 for the three months ended September 30, 2005, based on a weighted average number of shares of 4,391,052 and 4,401,454, respectively.

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

LIQUIDITY & CAPITAL RESOURCES

Cash and cash equivalents increased $629,000 from December 31, 2005, to $6,232,000 at September 30, 2006. Total cash of $8,731,000 at September 30, 2006 includes $2,500,000 of cash invested in a restricted money market account pledged as collateral for a bank loan. Accounts receivable were $2,293,000 at September 30, 2006, an increase of $861,000 from the $1,432,000 at December 31, 2005 due to the increased level of sales in the third quarter when compared to the fourth quarter of 2005; inventories decreased approximately $52,000 from $6,148,000 at December 31, 2005 to $6,097,000 at September 30, 2006.

Total current assets at September 30, 2006 were $16,123,000 compared to $16,853,000 at December 31, 2005. Working capital increased $1,167,000 when compared to December 31, 2005 as a result of our formal recasting of the Wachovia Bank balloon payment due in August 2006. Under the terms of the loan modification signed in the third quarter of 2006 (filed as Exhibit 10.1 hereto), we will continue to make the same installment payment of $92,500, plus interest, monthly until the obligation is satisfied in January 2009. The interest rate remained the same, at 50 basis points above the rate of interest paid on the cash collateral.

In August 2006, under the terms of a two-year lease, we leased warehouse space in Tampa, Florida, replacing an existing leased facility of similar size. Monthly rental and other terms remained similar to the previous lease.

As has been the case in the past, the bulk of our insurance policies come up for renewal in July; as a result, our prepaid expenses increased. Other than the above, we do not anticipate any significant capital expenditures in the near term and our management believes that there is sufficient cash on hand and working capital to satisfy upcoming requirements.

The Company does not have any off-balance sheet financing or similar arrangements.

NEW FINANCIAL ACCOUNTING STANDARDS

See Note 1 to the Financial Statements included in Part I, Item 1 for a discussion of new financial accounting standards.

DISCUSSION OF CRITICAL ACCOUNTING POLICIES

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America ("generally accepted accounting principles") 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 consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results would differ significantly from those estimates if different assumptions were used or unexpected events transpire. Please see Item 7 in the Company's Annual Report on Form 10-K for the year ended December 31, 2005 filed with the Securities and Exchange Commission.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

The Company does not participate in derivative or other financial instruments for which fair value disclosure would be required under SFAS No. 107. In addition, the Company does not invest in securities that would require disclosure of market risk, nor does it have floating rate loans or foreign currency exchange rate risks.

ITEM 4. CONTROLS AND PROCEDURES

(a) EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES: As of the end of the period covered by this quarterly report, an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures was performed under the supervision and with the participation of our management, including our principal executive officer and principal financial officer. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that a material weakness existed in our internal controls over financial reporting and consequently our disclosure controls and procedures were not effective, as of the end of the period covered by this quarterly report, in timely alerting them as to material information relating to our Company (including our consolidated subsidiaries) required to be included in this quarterly report.

The material weakness in our internal controls over financial reporting as of September 30, 2006 related to the fact that as a small public company, we have an insufficient number of personnel with clearly delineated and fully documented responsibilities and with the appropriate level of accounting expertise and we have insufficient documented procedures to identify and prepare a conclusion on matters involving material accounting issues and to independently review conclusions as to the application of generally accepted accounting principles. The lack of a

ITEM 4. CONTROLS AND PROCEDURES (continued)

sufficient number of accounting personnel is not considered appropriate for an internal control structure designed for external reporting purposes. The principal factors management considered in determining whether a material weakness existed in this regard was based upon management's evaluation discussed above and advice from our previous independent registered public accounting firm. As a result, management has determined that a material weakness in the effectiveness of the Company's internal controls over financial reporting existed as of September 30, 2006.

(b) CHANGES IN INTERNAL CONTROLS: No change in the Company's internal control over financial reporting occurred during this reporting period that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting. However, management of the Company, as well as the Audit Committee, recognizes that current staffing levels will have to be enhanced and/or institute arrangements with other accounting firms to act in a consulting capacity in an effort to satisfy our reporting obligations and over-all standards of disclosure controls and procedures.

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THE STEPHAN CO. AND SUBSIDIARIES
QUARTERLY REPORT PURSUANT TO SECTION 13
OF THE SECURITIES EXCHANGE ACT OF 1934
SEPTEMBER 30, 2006 AND 2005

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

See Note 3 to the Financial Statements included in Part I, Item 1 for a discussion of legal proceedings.

Other than the above, there has been no material change in the status of any other pending litigation since our last periodic report.

ITEM 6. EXHIBITS

10.1 Loan Modification Agreement with Wachovia Bank

31.1 Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer.

31.2 Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer.

32.1 Certification by the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification by the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted 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.

THE STEPHAN CO.

/s/ Frank F. Ferola

Frank F. Ferola
President and Chief Executive Officer
November 13, 2006

/s/ David A. Spiegel

David A. Spiegel
Principal Financial and
Accounting Officer
November 13, 2006

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