

CERAMICS PROCESS SYSTEMS CORP/DE/
Form 10-Q
August 02, 2006

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 period ended July 1, 2006

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 0-16088

CERAMICS PROCESS SYSTEMS CORPORATION

(Exact Name of Registrant as Specified in its Charter)

Delaware

04-2832409

(State or Other Jurisdiction
of Incorporation or Organization)

(I.R.S. Employer
Identification No.)

111 South Worcester Street
P.O. Box 338
Chartley MA
(Address of principal executive offices)

02712-0338

(Zip Code)

(508) 222-0614

Registrants Telephone Number, including Area Code:

Not Applicable

Former Name, Former Address and Former 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 than the registrant was required to file such reports), and (2) has been subject to the filing requirements for the past 90 days. Yes 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. (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 Act):

 Yes No

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuers classes of common stock, as of the latest practicable date. Number of shares of common stock outstanding as of July 26, 2006: 12,521,959

PART I FINANCIAL INFORMATION

ITEM 1 FINANCIAL STATEMENTS (Unaudited)

CERAMICS PROCESS SYSTEMS CORPORATION

Consolidated Balance Sheets (Unaudited)

(continued on next page)

| | July 01, 2006 | December 31, 2005 |
|--|------------------|----------------------|
| ASSETS | ----- | ----- |
| Current assets: | | |
| Cash and cash equivalents | \$ 779,882 | \$ 747,542 |
| Accounts receivable-trade | | |
| net of allowance for doubtful accounts | | |
| of \$5,461 | 1,607,515 | 1,233,088 |
| Inventories | 685,286 | 746,743 |
| Prepaid expenses | 59,221 | 51,706 |
| | ----- | ----- |
| Total current assets | 3,131,904 | 2,779,079 |
| | ----- | ----- |
| Property and equipment: | | |
| Production equipment | 3,657,918 | 3,363,604 |
| Furniture and office equipment | 121,349 | 107,147 |
| Leasehold improvements | 59,790 | -- |
| | ----- | ----- |
| Total cost | 3,839,057 | 3,470,751 |
| Accumulated depreciation | | |
| and amortization | (2,735,911) | (2,579,575) |
| | ----- | ----- |

| | | |
|-----------------------------|--------------|--------------|
| Property and equipment, net | 1,103,146 | 891,176 |
| | ----- | ----- |
| Total Assets | \$ 4,235,050 | \$ 3,670,255 |
| | ===== | ===== |

See accompanying notes to consolidated financial statements.

CERAMICS PROCESS SYSTEMS CORPORATION
Consolidated Balance Sheets (Unaudited)
(continued)

| LIABILITIES AND STOCKHOLDERS` | July 01, | December 31, |
|--|--------------|--------------|
| EQUITY | 2006 | 2005 |
| | ----- | ----- |
| Current liabilities: | | |
| Accounts Payable | \$ 455,175 | \$ 312,829 |
| Accrued Expenses | 389,154 | 280,357 |
| Current portion of obligations under capital leases | 210,043 | 214,054 |
| | ----- | ----- |
| Total current liabilities | 1,054,372 | 807,240 |
| Obligations under capital leases less current portion | 206,631 | 311,882 |
| | ----- | ----- |
| Total liabilities | 1,261,003 | 1,119,122 |
| | ----- | ----- |
| Stockholders` equity: | | |
| Common stock, \$0.01 par value, authorized 15,000,000 shares; issued 12,544,842 shares at July 1, 2006 and 12,349,092 at December 31, 2005 | 125,449 | 123,491 |
| Additional paid-in capital | 32,712,372 | 32,679,094 |
| Accumulated deficit | (29,802,939) | (30,190,617) |
| Less cost of 22,883 common shares repurchased | (60,835) | (60,835) |
| | ----- | ----- |
| Total stockholders` equity | 2,974,047 | 2,551,133 |

| | | |
|---|--------------|--------------|
| Total liabilities and stockholders` equity | \$ 4,235,050 | \$ 3,670,255 |
| | ===== | ===== |

See accompanying notes to consolidated financial statements.

CERAMICS PROCESS SYSTEMS CORPORATION
Consolidated Statements of Operations (Unaudited)

| | Fiscal Quarters Ended | | Six month Periods Ended | |
|---|-----------------------|------------------|-------------------------|------------------|
| | July 1, 2006 | June 25, 2005 | July 1, 2006 | June 25, 2005 |
| Product sales | \$ 2,628,020 | \$ 1,790,272 | \$ 5,134,844 | \$ 3,214,752 |
| Cost of product sales | 2,089,319 | 1,321,974 | 3,867,432 | 2,460,873 |
| Gross Margin | 538,701 | 468,298 | 1,267,412 | 753,879 |
| Selling, general, and administrative expense | 459,311 | 355,658 | 832,039 | 692,527 |
| Operating income | 79,390 | 112,640 | 435,373 | 61,352 |
| Other income(expense), net | (8,825) | (6,998) | (15,759) | (12,766) |
| Net income before income tax expense | 70,565 | 105,642 | 419,614 | 48,586 |
| Income tax expense | 6,704 | -- | 31,936 | -- |
| Net income | \$63,861 | \$105,642 | \$387,678 | \$48,586 |
| Net income per basic common share | \$ 0.01 | \$ 0.01 | \$ 0.03 | \$ 0.00 |
| Weighted average number of basic common shares | | | | |

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| | | | | |
|----------------------------|------------|------------|------------|------------|
| outstanding | 12,518,003 | 12,293,209 | 12,423,598 | 12,293,209 |
| | ===== | ===== | ===== | ===== |
| Net income per | | | | |
| diluted common share | \$ 0.00 | \$ 0.01 | \$ 0.03 | \$ 0.00 |
| | ----- | ----- | ----- | ----- |
| Weighted average number of | | | | |
| diluted common shares | | | | |
| outstanding | 13,131,799 | 13,052,377 | 13,005,312 | 12,672,793 |
| | ===== | ===== | ===== | ===== |

See accompanying notes to consolidated financial statements.

CERAMICS PROCESS SYSTEMS CORPORATION
Consolidated Statements of Cash Flows (Unaudited)

| | Six-Month Period Ended | |
|---|------------------------|------------------|
| | July 01, 2006 | June 25, 2005 |
| | ----- | ----- |
| Cash flows from operating activities: | | |
| Net income | \$387,678 | \$ 48,586 |
| Adjustments to reconcile net income to cash provided by operating activities: | | |
| Depreciation & amortization | 156,336 | 126,239 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable - trade | (374,427) | 289,759 |
| Inventories | 61,457 | (141,330) |
| Prepaid expenses | (7,515) | (42,120) |
| Accounts payable | 142,346 | (235,997) |
| Accrued expenses | 108,797 | (5,409) |
| | ----- | ----- |
| Net cash provided by operating activities | 474,672 | 39,728 |
| | ----- | ----- |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (368,306) | (133,480) |

| | | |
|--|-----------|------------|
| | ----- | ----- |
| Net cash used in investing activities | (368,306) | (133,480) |
| | ----- | ----- |
| Cash flows from financing activities: | | |
| Payment of capital lease obligations | (109,262) | (51,242) |
| Proceeds from issuance of common stock | 35,236 | -- |
| | ----- | ----- |
| Net cash used by financing activities | (74,026) | (51,242) |
| | ----- | ----- |
| Net (decrease) increase in cash and cash equivalents | 32,340 | (144,994) |
| Cash and cash equivalents at beginning of period | 747,542 | 457,947 |
| | ----- | ----- |
| Cash and cash equivalents at end of period | 779,882 | \$ 312,953 |
| | ===== | ===== |
| Supplemental cash flow information: | | |
| Acquisition of machinery under capital leases | -- | \$ 173,750 |
| Cash paid for taxes | \$ 17,000 | -- |
| Interest paid | \$ 15,759 | \$ 14,381 |

See accompanying notes to consolidated financial statements.

CERAMICS PROCESS SYSTEMS CORPORATION
Notes to Consolidated Financial Statement
(Unaudited)

(1) Nature of Business

Ceramics Process Systems Corporation (the "Company" or "CPS") develops, manufactures and markets advanced metal-matrix composite components for several end markets. Electronic applications account for a majority of the Company's sales today and include components for cellular basestations, heat spreaders for high-performance microprocessor and application-specific integrated circuits and components for electric motor controllers. The Company also produces components for use in optoelectronics, high brightness LED arrays and microwave / millimeter wave modules. The Company's products are typically in the form of housings, packages, lids, substrates, thermal planes, heat spreaders or baseplates, and are used in applications where thermal management and/or weight are important considerations.

In addition to serving electronics end markets, the Company is developing, manufacturing and beginning to market metal-matrix composite components for some structural end markets including robotic arms for capital equipment and specialty engine components.

The Company's products are manufactured by proprietary processes the Company has developed including the Quickset™ Injection Molding Process ("Quickset Process") and the QuickCast™ Pressure Infiltration Process

(`QuickCast Process`).

(2) Interim Consolidated Financial Statements

As permitted by the rules of the Securities and Exchange Commission applicable to quarterly reports on Form 10-Q, these notes are condensed and do not contain all disclosures required by generally accepted accounting principles.

The accompanying financial statements for the fiscal quarters and six-month periods ended July 1, 2006 and June 25, 2005 are unaudited. In the opinion of management, the unaudited consolidated financial statements of CPS reflect all normal recurring adjustments which are necessary to present fairly the financial position and results of operations for such periods.

The Company`s balance sheet at December 31, 2005 has been derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements.

For further information, refer to the consolidated financial statements and footnotes thereto included in the Registrant`s Annual Report on Form 10-K for the year ended December 31, 2005.

The consolidated financial statements include the accounts of CPS and its wholly-owned subsidiary, CPS Superconductor Corporation. All significant intercompany balances and transactions have been eliminated. The results of operations for interim periods are not necessarily indicative of the results to be expected for the full year.

(3) Recent Accounting Pronouncements

In November 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 151, "Inventory Costs, An Amendment of ARB No. 43, Chapter 4," which clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material (spoilage). The Company adopted SFAS No. 151 with the quarter ending April 1, 2006 and its adoption did not have a significant impact on results of operations or financial condition.

In December 2004, the FASB issued SFAS No. 123(R), "Share-Based Payment, an Amendment of FASB Statements No. 123 and 95." SFAS No. 123(R) establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services or incurs liabilities in exchange for goods or services that are based on the fair value of the entity`s equity instruments. SFAS No. 123(R) requires public entities to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award (with limited exceptions) and recognize the cost over the period during which an employee is required to provide service in exchange for the award. Adoption requires a modified prospective application whereby compensation expense is recognized on or after the required effective date for the portion of the outstanding awards for which the requisite service has not yet been rendered, based on the grant-date fair value of those awards calculated on a basis consistent with the SFAS No. 123 pro forma disclosures. Actual expense recorded related to these options would be reduced by future forfeitures. The Company adopted SFAS No. 123 (R) on its effective date at the beginning of the quarter ending April 1, 2006. Adoption of SFAS No. 123 (R) did not have a material effect on our financial statements as there were no unvested options outstanding as of December 31, 2005 and no options were granted in the quarter and six-month period ended July 1, 2006. The effect of adoption on future period results of operations will be dependent upon the terms of future option grants, if any.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections" which replaces Accounting Principles Board Opinion (APB) No. 20 "Accounting Changes" and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements". SFAS No. 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes retrospective application to the earliest practicable date, as the

required method for reporting a change in accounting principle and the reporting of a correction of an error. The provisions of SFAS No. 154 are effective for fiscal years beginning after December 15, 2005. The implementation of this standard did not impact our present financial statements and will only impact future financial statements to extent there are future accounting changes or error corrections.

In February 2006, the FASB published FASB Statement No. 155, "Accounting for Certain Hybrid Financial Instruments". SFAS No. 155 amends SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" and No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." Among other things, the Statement resolves issues related to the financial reporting of certain hybrid financial instruments (financial instruments that have embedded derivatives) to be accounted for as a whole at fair value if the holder elects this option. This accounting eliminates the need to bifurcate the derivative from its host. The Statement also eliminates certain previous guidance that provided that beneficial interests in securitized financial assets are not subject to the provisions of SFAS No. 133. Lastly, the Statement also eliminates a restriction on the passive derivative instruments that a qualifying special purpose entity may hold. Management does not expect the adoption of this Statement to have a material impact on the Company's consolidated financial statements.

(4) Net Income (Loss) Per Common and Common Equivalent Share

Basic net income or net loss per common share is calculated by dividing net income or loss by the weighted average number of common shares outstanding during the period. Diluted net income per common share is calculated by dividing net income by the sum of the weighted average number of common shares plus additional common shares that would have been outstanding if potential dilutive common shares had been issued for granted stock option and stock purchase rights. Common stock equivalents are excluded from the diluted calculations if a net loss is incurred as they would be anti-dilutive.

The following table presents the calculation of both basic and diluted EPS:

| | Quarters Ended | | Six-Month Periods Ended | |
|--|------------------|------------------|-------------------------|------------------|
| | July 01, 2006 | June 25, 2005 | July 01, 2006 | June 25, 2005 |
| | ----- | ----- | ----- | ----- |
| Basic EPS Computation: | | | | |
| Numerator: | | | | |
| Net income | \$ 63,861 | \$ 105,642 | \$ 387,678 | \$ 48,586 |
| Denominator: | | | | |
| Weighted average Common shares Outstanding | 12,518,003 | 12,293,209 | 12,423,598 | 12,293,209 |
| Basic EPS | \$ 0.01 | \$ 0.01 | \$ 0.03 | \$ 0.00 |
| Diluted EPS Computation: | | | | |
| Numerator: | | | | |
| Net income | 63,861 | 105,642 | 387,678 | 48,586 |

Denominator:

| | | | | |
|-----------------------------------|------------|------------|------------|------------|
| Weighted average Common shares | | | | |
| Outstanding | 12,518,003 | 12,293,209 | 12,423,598 | 12,293,209 |
| Stock options | 613,796 | 759,168 | 581,714 | 379,584 |
| Total Shares | 13,131,799 | 13,052,377 | 13,005,312 | 12,672,793 |
| Diluted EPS | \$ 0.00 | \$ 0.01 | \$ 0.03 | \$ 0.00 |

(5) Stock-based Compensation Plans

Prior to 2006 the Company accounted for its stock-based compensation plans under Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees". The following table illustrates the effect on net income and earnings per share as if the Company had applied the fair value recognition provision of SFAS No. 123, "Accounting for Stock-based Compensation," to stock-based employee compensation for the quarter and six-month periods ended June 25, 2005.

| | Quarter Ended June 25, 2005 | Six-month Period Ended June 25, 2005 |
|---|--------------------------------|--|
| | ----- | ----- |
| Net income as reported | \$ 105,642 | \$ 48,586 |
| Deduct total stock-based employee compensation expense determined under fair value method for all awards | (20,221) | (43,971) |
| | ----- | ----- |
| Pro forma net income | 85,421 | 4,615 |
| | ===== | ===== |
| Basic shares outstanding | 12,293,209 | 12,293,209 |
| Diluted shares outstanding | 13,052,377 | 12,672,793 |
| Earnings per share, as reported | | |
| Basic | \$ 0.01 | \$ 0.00 |
| Diluted | \$ 0.01 | \$ 0.00 |
| Earnings per share, pro forma | | |
| Basic | \$ 0.01 | \$ 0.00 |
| Diluted | \$ 0.01 | \$ 0.00 |

The Company adopted SFAS No. 123 (R) on its effective date, commencing with the quarter ending April 1, 2006. Adoption of SFAS No. 123 (R) did not have a material effect on our financial statements for the quarter and six-month period ended July 1, 2006 as there were no unvested options outstanding as of December 31, 2005 and no options were granted in the quarter and six month period ended July 1, 2006.

The Company adopted the 1999 Stock Incentive Plan ("1999 Plan") on January 22, 1999. Under the terms of the 1999 Plan all of the Company's employees, officers, directors, consultants and advisors are eligible to be granted options, restricted stock awards, or other stock-based awards. All options were nonstatutory stock options granted at the fair market value of the stock, and expire ten years from the date of grant. All options granted to employees originally vested in equal annual installments over a five-year period. All options granted to directors originally vested one year from date of grant. In December 2005 the Board of Directors approved a resolution fully vesting all outstanding stock options as of December 20, 2005. The Board of Directors took this action in anticipation of the Company adopting SFAS No. 123(R) as of fiscal 2006.

Under the 1999 Plan a total of 1,250,000 shares of common stock are available for issuance, of which 145,750 shares remain available for grant as of July 1, 2006.

As of July 1, 2006 the 1999 Plan is the only stock option plan from which awards can be made as all other option plans have expired. The 1989 Stock Option Plan expired on February 22, 1999 and no additional grants can be made from this plan. A total of 5,000 options granted under the 1989 Stock Option Plan prior to its expiration date were outstanding as of July 1, 2006.

The fair value of each option award is estimated on the date of grant using the Black-Scholes option valuation model. Expected volatilities are based on the historical volatility of the Company's stock and other factors. The Company uses historical data to estimate option exercise and employee termination within the valuation model. The expected term of options granted represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

A summary of option activity under the Plan as of July 1, 2006, and changes during the six-month period then ended is presented below:

| <u>Options</u> | <u>Shares</u> <u>(000)</u> | <u>Weighted-</u> <u>Average</u> <u>Exercise</u> <u>Price</u> | <u>Weighted-</u> <u>Average</u> <u>Remaining</u> <u>Contractual</u> <u>Term (years)</u> | <u>Aggregate</u> <u>Intrinsic</u> <u>Value</u> <u>(\$000)</u> |
|-----------------------------|-------------------------------|---|---|--|
| Outstanding at Dec 31, 2005 | 1,305,363 | \$ 0.58 | 5.79 | \$ 613,520 |
| Granted | -- | -- | -- | -- |
| Exercised | 195,750 | \$ 0.18 | -- | \$ 131,505 |
| Forfeited or expired | 363 | \$ 0.18 | -- | -- |
| Outstanding at July 1, 2006 | 1,109,250 | \$ 0.65 | 5.15 | \$ 942,863 |
| Exercisable at July 1, 2006 | 1,109,250 | \$ 0.65 | 5.15 | \$ 942,863 |

As of July 1, 2006, there was no unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Plans.

(6) Inventories

Inventories consist of the following:

| | July 01, 2006 | December 31, 2005 |
|-----------------|------------------|----------------------|
| | ----- | ----- |
| Raw materials | \$ 78,082 | \$ 41,486 |
| Work in process | 285,750 | 270,282 |
| Finished goods | 321,454 | 434,975 |
| | ----- | ----- |
| Inventories | \$ 685,286 | \$ 746,743 |
| | ===== | ===== |

(7) Accrued Expenses

Accrued expenses consist of the following:

| | July 01, 2006 | December 31, 2005 |
|------------------------------|------------------|----------------------|
| | ----- | ----- |
| Accrued legal and accounting | \$ 36,577 | \$ 45,475 |
| Accrued payroll | 307,600 | 207,572 |
| Accrued other | 20,041 | 17,310 |
| Accrued income tax payable | 24,936 | 10,000 |
| | ----- | ----- |
| | \$ 389,154 | \$ 280,357 |
| | ===== | ===== |

(8) Line of Credit and Equipment Lease Facility Agreements

In April 2005, the Company entered line of credit and equipment lease agreements with Sovereign Bank. The line of credit is a revolving credit facility allowing the Company to borrow up to 80% of eligible accounts receivable, up to a maximum of \$1 million, subject to the Company complying with certain covenants. The line of credit has a one year term and has been extended to May 2007. As of July 1, 2006 there were no borrowings under the line of credit.

The equipment lease facility allows the Company to lease up to \$1 million of eligible capital equipment from Sovereign Bank. As of July 1, 2006, the Company has leased capital equipment with a value of \$453 thousand from Sovereign Bank under the lease facility agreement.

(9) Income Taxes

At December 31, 2005, the Company had approximately \$9,400,000 of net operating loss carryforwards available to offset income for U.S. Federal income tax purpose. The Company has established a valuation allowance against this and its other deferred tax assets.

The Company recorded no tax provision for federal income taxes during the quarter ended July 1, 2006 due to net operating loss carryforwards and a valuation reserve against deferred tax assets. The Company will continue to consider the need and amount of the valuation allowance against the deferred tax assets based upon its ongoing assessment of historical and projected taxable income. The Company recorded a tax provision of \$7 and \$32 thousand for state income taxes during the quarter and six-months ended July 1, 2006, respectively.

(10) Subsequent Event

In July 2006 the Company entered into a lease for its current operating facilities of approximately 37,520 square feet of rentable space located on approximately seven acres at its current sight in Chartley, MA. The term of the lease is ten years. The lease is a triple net lease wherein the Company is responsible for payment of all real estate taxes, operating costs and utilities. The Company also has an option to buy the property and a first right of refusal during the term of the lease. Annual rental payments are \$100 thousand in year one increasing to \$150 thousand in year ten.

ITEM 2 MANagements DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of financial condition and results of operations is based upon and should be read in conjunction with the consolidated financial statements of the Company and notes thereto included in this report and the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements that involve a number of risks and uncertainties. There are a number of factors that could cause the Company's actual results to differ materially from those forecasted or projected in such forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements which speak only as of the date hereof. The Company undertakes no obligation to publicly release the results of any revisions to these forward-looking statements which may be made to reflect events or changed circumstances after the date hereof or to reflect the occurrence of unanticipated events.

Critical Accounting Policies

The critical accounting policies utilized by the Company in preparation of the accompanying consolidated financial statements are set forth in Part II, Item 7 of the Company's Annual Report on Form 10-K for the year ended December 31, 2005, under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations". There have been no material changes to these policies since December 31, 2005 except as described in Note 3 to the Consolidated Financial Statements.

Results of Operations for Second Fiscal Quarter of 2006 (Q2 2006) Compared to the Second Fiscal Quarter of 2005 (Q2 2005)

Total revenue was \$2,628 thousand in Q2 2006, a 47% increase from total revenue of \$1,790 thousand in Q2 2005. The increase in revenues came from higher demand for existing products and well as demand for new products which entered production in Q2 2006. Unit demand increased for flip-chip heat spreaders, motor controller baseplates and wireless basestations components. In addition the Company achieved several design wins for flip-chip heat spreaders, motor controller baseplates and other products which management believes will generate growth in the future.

Total operating expenses in Q2 2006 were \$2,549 thousand, a 52% increase from total operating expenses in Q2 2005 of \$1,678 thousand. Cost of product sales in Q2 2006 were \$2,089 thousand, an increase of 58% from cost of product

sales in Q2 2005 of \$1,322 thousand. Cost of product sales increased primarily as a result of increased unit shipments and secondarily because of product mix changes, lower than typical yields on a new product which entered production in Q2 2006, and expenses incurred in preparation for the introduction of certain new products in the second half of the year. Management believes that yields will improve on this product as production continues. Gross profit on product sales in Q2 2006 was 20% compared to gross profit on product sales in Q2 2005 of 26%. This decrease in gross profit is primarily the result of product mix changes and lower than typical yields on a new product which entered production in Q2 2006, and expenses incurred in preparation for the introduction of certain new products in the second half of the year.

Selling, general and administrative (SG&A) expenses were \$459 thousand in Q2 2006, a 29% increase from SG&A expenses of \$356 thousand in Q2 2005. The increase in SG&A expenses is primarily the result of accruing for benefits paid pursuant to a severance agreement, higher commissions paid to sales representatives and higher sales promotion expenses.

Results of Operations for First Six Months 2006 Compared to First Six Months of 2005

Total revenue was \$5,135 thousand in the first six months of 2006, a 60% increase from total revenue of \$3,215 thousand in the first six months of 2005. The increase in revenues came primarily from higher demand for existing products and secondarily from demand for new products which entered production in the first six months of 2006. The largest increase in demand was for lids and heatspreaders for application-specific integrated circuits.

Total operating expenses in the first six months of 2006 were \$4,699 thousand, a 49% increase from total operating expenses of \$3,153 thousand in the first six months of 2005. Cost of product sales in the first six months of 2006 were \$3,867 thousand, a 57% increase from cost of product sales of \$2,461 thousand in the first six months of 2005. Cost of product sales increased primarily as a result of increased unit shipments. Gross profit on product sales in the first six months of 2006 was 25% compared with gross profit on product sales of 23% in the first six months of 2005. This increase in gross profit is primarily the result of higher prices for certain products which went into effect during the first six months of 2006.

Selling, general and administrative (SG&A) expenses were \$832 thousand in the first six months of 2006, a 20% increase from SG&A expenses of \$693 thousand in the first six months of 2005. The increase in SG&A expenses is primarily the result of accruing for benefits paid pursuant to a severance agreement, higher commissions paid to sales representatives and higher sales promotion expenses.

Liquidity and Capital Resources

The Company's cash balance and cash equivalents at July 1, 2006 was \$780 thousand compared to cash balance and cash equivalents at December 31, 2005 of \$748 thousand, an increase of \$32 thousand or 4%.

Accounts receivable increased to \$1,608 thousand at July 1, 2006 from \$1,233 thousand at December 31, 2005. This change reflects higher revenues in Q2 2006 compared to Q4 2005. The accounts receivable balance at July 1, 2006 and December 31, 2005 is net of allowance for doubtful accounts of \$5 thousand.

Inventories decreased to \$685 thousand at July 1, 2006 from \$747 thousand at December 31, 2005; this decrease is primarily the result of higher than expected sales near the end of Q2 2006 by customers with whom the Company has consigned inventory agreements.

The Company financed its working capital during Q2 2006 and the six month period ending July 1, 2006 with existing cash balances and funds generated by operations. The Company expects it will continue to be able to fund its working capital requirements for the remainder of 2006 from these same sources.

The Company continues to sell to a limited number of customers and the loss of any one of these customers could cause the Company to require additional external financing. Failure to generate sufficient revenues, raise additional capital or reduce certain discretionary spending could have a material adverse effect on the Company's ability to achieve its business objectives.

Contractual Obligations

In April 2005, the Company entered line of credit and equipment lease agreements with Sovereign Bank. The line of credit is a revolving credit facility allowing the Company to borrow up to 80% of eligible accounts receivable, up to a maximum of \$1 million, subject to the Company complying with certain covenants. The line of credit has a one-year term. Immediately prior to expiring in April 2006 the term was extended to May 2006, and then in May the term was extended for one year to May 2007. As of July 1, 2006 there were no borrowings under the line of credit.

The equipment lease facility allows the Company to lease up to \$1 million of eligible capital equipment. As of July 1, 2006, the Company has leased capital equipment with a value of \$453 thousand under the lease facility agreement.

As of July 1, 2006, production equipment included \$305 thousand of construction in progress, and in addition, the Company had outstanding commitments to purchase \$26 thousand of production equipment. The Company intends to finance \$195 thousand of production equipment in construction in progress and outstanding commitments under the lease agreement.

The Company's contractual obligations at July 1, 2006 consist of the following:

| | | <u>Payments Due by Period</u> | | | |
|---|--------------|---------------------------------|------------------------------|------------------------------|-------------------------------|
| | <u>Total</u> | <u>Remaining in FY 2006</u> | <u>FY 2007 - FY 2009</u> | <u>FY 2010 - FY 1012</u> | <u>FY 2013 and beyond</u> |
| Capital lease obligations including interest | \$ 461,807 | \$ 112,919 | \$ 348,888 | \$ -- | -- |
| Purchase commitments for production equipment | \$ 26,323 | \$ 26,323 | -- | -- | -- |

ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is not significantly exposed to the impact of interest rate changes or foreign currency fluctuations. The Company has not used derivative financial instruments.

ITEM 4 CONTROLS AND PROCEDURES

(a) The Company's Chief Executive Officer and Principal Financial Officer have evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-14(c) and 15d - 14(c) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this Form 10-Q (the "Evaluation Date"). Based on such evaluation, such officer has concluded that, as of the Evaluation Date, 1) the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports the Company files under the Securities Exchange Act is recorded, processed, summarized and

reported within the time periods specified in the rules and forms of the SEC and 2) the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is accumulated and communicated to our management, including our chief executive officer and chief financial officer, to allow timely decisions regarding required disclosure.

(b) Changes in Internal Controls. There has been no change in our internal control over financial reporting that occurred during our most recent fiscal quarter that has materially affected or is 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 have been no material changes to the risk factors as discussed in our 2005 Form 10-K

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

None.

ITEM 3 DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not applicable.

ITEM 5 OTHER INFORMATION

Not applicable.

ITEM 6 EXHIBITS AND REPORTS ON FORM 8-K:

(a) Exhibits:

Exhibit 31.1 Certification Of Chief Executive Officer Pursuant To 18 U.S.C. Section 1350, As Adopted Pursuant To Section 302 Of The Sarbanes-Oxley Act Of 2002

Exhibit 31.2 Certification Of Chief Financial Officer Pursuant To 18 U.S.C. Section 1350, As Adopted Pursuant To Section 302 Of The Sarbanes-Oxley Act Of 2002

Exhibit 32.1 Certification Pursuant To 18 U.S.C. Section 1350, As Adopted Pursuant To Section 906 Of The Sarbanes-Oxley Act Of 2002

b. Reports on Form 8-K

On July 24, 2006, the Company filed a report on Form 8-K relating to the Company entering into a 10-year commercial lease with Gifford Investments for use of buildings and real estate located at 111 South Worcester Street, Chartley, Massachusetts 02712.

On August 2, 2006, the Company filed a report on Form 8-K relating to the announcement of its financial results for

the fiscal quarter ended July 1, 2006, as presented in a press release dated August 2, 2006.

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.

Ceramics Process Systems Corporation

(Registrant)

Date: August 2, 2006

/s/ Grant C. Bennett

Grant C. Bennett

President