

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10 - QSB**

(Mark One)

Quarterly report under section 13 or 15(d) of the Securities Exchange Act of 1934.

For the quarterly period ended September 30, 2006

or

Transition report under section 13 or 15(d) of the Securities Exchange Act of 1934.

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-7441

**SIERRA MONITOR CORPORATION**

(Exact name of small business issuer as specified in its charter)

California  
(State or other jurisdiction of  
incorporation or organization)

95-2481914  
(I.R.S. Employer  
Identification  
No.)

1991 Tarob Court  
Milpitas, California 95035

(Address and zip code of principal executive offices)

(408) 262-6611  
(Issuer's telephone number, including area code)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 \_\_\_

The number of shares of the issuer's common stock outstanding, as of November 7, 2006 was 11,055,192.

Transitional Small Business Disclosure Format: Yes \_\_\_ ; No X

**PART I: FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

**SIERRA MONITOR CORPORATION**

**Condensed Balance Sheet**

September 30, 2006

(Unaudited)

**Assets**

Current assets:

Cash	\$ 334,496
Trade receivables, less allowance for doubtful accounts of approximately \$60,000	1,826,743
Inventories, net	2,128,971
Prepaid expenses	130,094
Deferred income taxes	214,329
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Total current assets	4,634,633
Property and equipment, net	110,799
Deferred income taxes	87,045
Other assets	142,345
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Total assets	\$ 4,974,822

**Liabilities and Shareholders' Equity**

Current liabilities:

Accounts payable	\$ 787,863
Accrued compensation expenses	353,344
Bank borrowings	100,000
Income taxes payable	60,281
Other current liabilities	69,716
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Total current liabilities	1,371,204

Commitments and contingencies

Shareholders' equity:

Common stock, \$0.001 par value; 20,000,000 shares authorized; 11,055,192 shares issued and outstanding	11,055
Additional paid-in capital	3,267,563
Retained earnings	325,000
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Total shareholders' equity	3,603,618
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Total liabilities and shareholders' equity	\$ 4,974,822

See accompanying notes to the condensed financial statements.

**SIERRA MONITOR CORPORATION**

**Condensed Statements of Operations**

(Unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2006	2005	2006	2005
Net sales	\$ 2,706,751	\$ 2,204,755	\$ 7,863,672	\$ 6,421,833
Cost of goods sold	1,018,368	903,242	3,088,854	2,623,773
Gross profit	1,688,383	1,301,513	4,774,818	3,798,060
Operating expenses				
Research and development	466,990	433,109	1,336,351	1,288,441
Selling and marketing	562,855	553,801	1,860,360	2,011,833
General and administrative	311,945	302,474	998,662	960,064
	1,341,790	1,289,384	4,195,373	4,260,338
Income (loss) from operations	346,593	12,129	579,445	(462,278)
Interest income (expense)	(3,704)	(1,319)	(12,429)	(1,319)
Income (loss) before income taxes	342,889	10,810	567,016	(463,597)
Income tax (benefit) provision	136,802	4,325	226,807	(185,439)
Net income (loss)	\$ 206,087	\$ 6,485	\$ 340,209	\$ (278,158)
Net income (loss) available to common shareholders per common share				
Basic:	\$ 0.02	\$ 0.00	\$ 0.03	\$ (0.03)
Diluted:	\$ 0.02	\$ 0.00	\$ 0.03	\$ (0.03)
Weighted average number of shares used in per share computations				
Basic:	11,050,539	11,019,879	11,048,988	10,993,768
Diluted:	11,479,136	11,473,069	11,542,967	10,993,768

See accompanying notes to the condensed financial statements.

SIERRA MONITOR CORPORATION

Condensed Statements of Cash Flows

(Unaudited)

	Nine months ended September 30,	
	<u>2006</u>	<u>2005</u>
Cash flows from operating activities:		
Net income (loss)	\$ 340,209	\$ (278,154)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	104,876	114,063
Provision for bad debt expense	6,834	8,573
Provision for inventory losses	(25,984)	10,602
Deferred income taxes	166,312	(185,825)
Warrants compensation expense	-	30,800
Stock based compensation expense	32,787	-
Changes in operating assets and liabilities:		
Trade receivables	(580,639)	(14,607)
Inventories	(436,276)	(84,844)
Prepaid expenses and other current assets	(45,418)	52,353
Other assets	26	324
Accounts payable	159,329	(116,648)
Income taxes payable	59,039	(1,456)
Accrued compensation expenses	95,701	(9,786)
Other current liabilities	(7,683)	(23,717)
Net cash used in operating activities	<u>(130,887)</u>	<u>(498,322)</u>
Cash flows from investing activities:		
Capital expenditures	(49,108)	(71,404)
Acquisition of other long-term assets	(44,750)	-
Net cash used in investing activities	<u>(93,858)</u>	<u>(71,404)</u>
Cash flows from financing activities:		
Proceeds from bank borrowings	100,000	200,000
Repayments made to bank borrowings	(200,000)	-
Proceeds from exercise of stock options	3,238	12,100
Net cash provided by financing activities	<u>(96,762)</u>	<u>212,100</u>
Net decrease in cash	(321,507)	(357,626)
Cash at beginning of period	656,003	788,688
Cash at end of period	\$ <u>334,496</u>	\$ <u>431,062</u>
Supplemental cash flow information		
Cash paid for income taxes	\$ <u>1,046</u>	\$ <u>3,292</u>
Cash paid for interest	\$ <u>12,429</u>	\$ <u>1,319</u>

See accompanying notes to the condensed financial statements.

## SIERRA MONITOR CORPORATION

### Notes to the Unaudited Interim Condensed Financial Statements

September 30, 2006

#### **Basis of Presentation**

The accompanying unaudited interim condensed financial statements have been prepared by Sierra Monitor Corporation (the "Company"), pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted pursuant to such SEC rules and regulations; nevertheless, the Company believes that the disclosures are adequate to make the information presented not misleading. These financial statements and the notes hereto should be read in conjunction with the financial statements, accounting policies and notes thereto included in the Company's Annual Report on Form 10-KSB for the year ended December 31, 2005, which was filed with the SEC on March 30, 2006. In the opinion of the Company, all adjustments, including normal recurring adjustments necessary to present fairly the financial position, results of operations, and cash flows of Sierra Monitor Corporation for the interim periods have been included. The results of operations for the interim period are not necessarily indicative of the results for the full year.

#### **Summary of Business**

Sierra Monitor Corporation was founded in 1978 to design and develop hazardous gas monitoring devices for protection of personnel and facilities in industrial workplaces. In addition to gas monitoring systems, the Company also manufactures microprocessor-based systems used to monitor and control environmental conditions in small, remote structures used for cellular and hard wire telephone equipment. The Company also manufactures a line of products known as communications bridges. These products provide a means for many industrial instruments to communicate with each other even when they have different communication protocols. Communications bridges are sold under the name FieldServer by the FieldServer Technologies Division of the Company. In addition, the Company provides technical support and training for its gas detection and environment controller products and custom development of its FieldServer products.

Gas monitoring products manufactured by the Company are sold primarily to oil and gas drilling and refining companies, chemical plants, waste-water treatment plants, companies in the semiconductor industry and are used in other applications which involve the handling or generation of hazardous gases. Environment controllers, which provide management of environmental conditions in small structures such as local DSL distribution nodes and buildings at cell tower sites ("cell sites"), are sold to telecommunications companies and their suppliers. FieldServers are typically sold to integration companies that service building and plant automation projects.

The Company's common stock is quoted on the OTC Bulletin Board under the symbol "SRMC.OB".

#### **Accounting Policies**

##### **a) Revenue Recognition**

The Company recognizes revenues in accordance with Staff Accounting Bulletin ("SAB") No. 104, "Revenue Recognition," when all of the following conditions exist: a) persuasive evidence of an arrangement exists in the form of an accepted purchase order; b) delivery has occurred, based on shipping terms, or services have been rendered; c) the Company's price to the buyer is fixed or

determinable, as documented on the accepted purchase order; and d) collectibility is reasonably assured. By product and service type, revenues are recognized when the following specific conditions are met:

#### *Gas Detection and Environment Control Products*

Gas Detection and Environment Control products are sold as off-the-shelf products with prices fixed at the time of order. Orders delivered to the Company by phone, fax, mail or email are considered valid purchase orders and once accepted by the Company are deemed to be the final understanding between us and our customer as to the specific nature and terms of the agreed-upon sale transaction. Products are shipped and are considered delivered when (a) for FOB factory orders they leave our shipping dock or (b) for FOB customer dock orders upon confirmation of delivery. The creditworthiness of customers is generally assessed prior to the Company accepting a customer's first order. Additionally, international customers and customers who have developed a history of payment problems are generally required to prepay or pay through a letter-of-credit.

#### *Gas Detection and Environment Control Services*

Gas Detection and Environment Control Services consist of field service orders (technical support) and training, which are provided separate from product orders. Orders are accepted in the same forms as discussed for Gas Detection and Environment Control Products above with hourly prices fixed at the time of order. Revenue recognition occurs only when the service activity is completed. Such services are provided to current and prior customers, and, as noted above, creditworthiness has generally already been assessed by the time the services have been performed. In cases where the probability of receiving payment is low, a credit card number is collected for immediate processing.

#### *FieldServer Products*

FieldServer products are sold in the same manner as Gas Detection and Environment Control products (as discussed above) except that the products contain embedded software, which is integral to the operation of the device. The software embedded in FieldServer products includes two items: (a) a compiled program containing (i) the basic operating system for FieldServers, which is common to every unit, and (ii) the correct set of protocol drivers based on the customer order (see FieldServer Services below for more information); and (b) a configuration file that identifies and links each data point as identified by the customer. The Company does not deem the hardware, operating systems with protocol drivers and configuration files to be separate units of accounting, as defined in EITF 00-21, "*Revenue Arrangements with Multiple Deliverables*," because the Company does not believe that they have value on a stand-alone basis. The hardware is useless without the software, and the software is only intended to be used in FieldServer hardware. Additionally, the software included in each sale is deemed to not require significant production, modification or customization, as described in Statement of Position (SOP) 97-02, "*Software Revenue Recognition*", as amended, and therefore the Company recognizes revenues upon the shipment or delivery of products (depending on shipping terms), as described in Gas Detection and Environment Control Products above.

#### *FieldServer Services*

FieldServer services consist of orders for custom development of protocol drivers. Generally customers place orders for FieldServer products concurrently with their order for protocol drivers. However if custom development of the protocol driver is required, the product order is not processed until development of the protocol driver is complete. Orders are received in the same manner as described in *FieldServer Products* above, but due to the non-recurring engineering aspect of the customized driver development the Company is more likely to have a written evidence trail of a quotation

and a hard copy order. The driver development involves further research after receipt of order, preparation of a scope document to be approved by the customer and then engineering time to write, test and release the driver program. When development of the driver is complete the customer is notified and can proceed with a FieldServer product (see FieldServer Products above). Revenues for driver development are billed and recognized upon shipment or delivery of the related product that includes the developed protocol drivers (as noted in FieldServer Products above). Collectibility is reasonably assured as described in FieldServer Products above.

#### Discounts and Allowances

Discounts are applied at time of order entry and sales are processed at net pricing. No allowances are offered to customers.

#### **b) Recent Accounting Standards**

Other than the adoption of SFAS No. 123(R) (see Employee Stock-Based Compensation below), recent accounting pronouncements discussed in the notes to the December 31, 2005 audited financial statements, filed previously with the Securities and Exchange Commission in Form 10-KSB, that were required to be adopted during the year ending December 31, 2006, did not have or are not expected to have a significant impact on the Company's 2006 financial statements.

#### **c) Employee Stock-Based Compensation**

At September 30, 2006, the Company had one approved stock-based employee compensation plan, the 2006 Stock Plan. The Company's 1996 Stock Plan expired by its terms in March 2006, but the 1996 Stock Plan will continue to govern awards previously granted thereunder.

Under the 2006 Stock Plan the Company initially reserved 500,000 shares of common stock for issuance. Options are granted under the Stock Plans at the fair market value of the Company's common stock at the grant date, vest ratably over 5 years, and expire 10 years from the grant date. Prior to January 1, 2006, the Company accounted for grants for these plans under Accounting Principals Board Opinion ("APB") No. 25, *"Accounting for Stock Issued to Employees"* ("APB 25") and related interpretations, and applied SFAS No. 123, *"Accounting for Stock-Based Compensation,"* as amended by Statement of Financial Accounting Standards ("SFAS") No. 148, *"Accounting for Stock-Based Compensation - Transition and Disclosure,"* for disclosure purposes only. Under APB 25, stock-based compensation cost related to stock options was not recognized in net income since the options underlying those plans had exercise prices greater than or equal to the market value of the underlying stock on the date of the grant.

Effective January 1, 2006, the company adopted SFAS No. 123 (revised 2004), *"Share Based Payment,"* which revises SFAS No. 123 and supersedes APB 25. SFAS No. 123(R) requires that all share-based payments to employees be recognized in the financial statements based on their fair values at the date of grant. The calculated fair value is recognized as expense (net of any capitalization) over the requisite service period, net of estimated forfeitures, using the straight-line method under SFAS No. 123(R). The Company considers many factors when estimating expected forfeitures, including types of awards, employee class and historical experience. The statement was adopted using the modified prospective method of application which requires compensation expense to be recognized in the financial statements for all unvested stock options beginning in the quarter of adoption. No adjustments to prior periods have been made as a result of adopting SFAS No. 123(R). Under this transition method, compensation expense for share-based awards granted prior to January 1, 2006, but not yet vested as of January 1, 2006, will be recognized in the Company's financial statements over their remaining service period. The cost

will be based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123. As required by SFAS No. 123(R), compensation expense recognized in future periods for share-based compensation granted prior to adoption of the standard will be adjusted for the effects of estimated forfeitures.

For the three and nine month periods ended September 30, 2006, the impact of adopting SFAS No. 123(R) on the Company's condensed statements of operations was an increase in salaries and benefits expense of \$10,929 and \$32,787, respectively, with a corresponding decrease in the Company's income from continuing operations, income before provision for income taxes and net income resulting from the first-time recognition of compensation expense associated with employee stock options. There was no material impact on the Company's basic and diluted net income per share as a result of the adoption of SFAS No. 123(R).

The adoption of SFAS No. 123(R) had no significant effect on net cash flow.

The following table illustrates the pro forma net income and earnings per share that would have resulted in the three and nine month periods ended September 30, 2005 from recognizing compensation expense associated with accounting for employee stock-based awards under the provisions of SFAS No. 123(R). The reported and pro forma net income and earnings per share for the three and nine month periods ended September 30, 2006 are provided for comparative purposes only, since stock-based compensation expense is recognized in the financial statements under the provisions of SFAS No.123(R).

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Net income (loss):				
As reported	\$ 206,087	\$6,485	\$ 340,209	\$(278,158)
Add: Stock-based employee compensation included in net income (loss)	10,929	—	32,787	—
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards	<u>\$ (10,929)</u>	<u>\$ (38,000)</u>	<u>\$ (32,787)</u>	<u>\$(115,000)</u>
Pro forma	<u>\$ 206,087</u>	<u>\$ (31,515)</u>	<u>\$ 340,209</u>	<u>\$(393,158)</u>
Basic and diluted net income (loss) per share:				
As reported	<u>\$ 0.02</u>	<u>\$ 0.00</u>	<u>\$ 0.03</u>	<u>\$ (0.03)</u>
Pro forma	<u>\$ 0.02</u>	<u>\$ 0.00</u>	<u>\$ 0.03</u>	<u>\$ (0.04)</u>

### **Inventories**

A summary of inventories as of September 30, 2006 follows:

Raw Materials	\$ 917,831
Work-in-process	1,090,286
Finished goods	224,195
Obsolescence reserve	(103,341)
	<u>\$ 2,128,971</u>

### **Net income (loss) per share**

Basic earnings per share (“EPS”) is computed using the weighted average number of common shares outstanding during the period. Diluted EPS is computed using the weighted average number of common and dilutive potential common shares outstanding during the period. Dilutive potential common shares consist of common stock issuable upon exercise of stock options using the treasury stock method. No adjustments to earnings were made for purposes of per share calculations.

The Company reported a net loss for the nine month periods ended September 30, 2005. As a result, 815,000 shares of common stock issuable upon exercise of stock options were excluded from the calculation of diluted loss per share for the nine month periods ended September 30, 2005 because their inclusion would be anti-dilutive. At September 30, 2006, and 2005, outstanding options to acquire 360,000 shares and 336,500 shares, respectively, of common stock were not considered potentially dilutive common shares due to the exercise price being higher than the stock price used in the EPS calculation.

The following is a reconciliation of the shares used in the computation of basic and diluted EPS for the three and nine month periods ended September 30, 2006 and 2005, respectively:

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>9/30/2006</b>	<b>9/30/2005</b>	<b>9/30/2006</b>	<b>9/30/2005</b>
Basic EPS – weighted-average number of common shares outstanding	11,050,539	11,019,879	11,048,988	10,993,768
Effect of dilutive potential common shares – stock options outstanding	<u>428,597</u>	<u>453,190</u>	<u>493,979</u>	<u>-</u>
Diluted EPS – weighted-average number of common shares and potential common shares outstanding	<u>11,479,136</u>	<u>11,473,069</u>	<u>11,542,967</u>	<u>10,993,768</u>

### **Comprehensive Income**

The Company has no significant components of other comprehensive income and, accordingly, comprehensive income is the same as net income for all periods presented.

### **Concentrations**

Two customers made up approximately 30% of accounts receivable at September 30, 2006; no other customer individually made up more than 10% of accounts receivable at such date. Also, no customers individually made up more than 10% of net sales for the nine month period ended September 30, 2006.

### **Segment Information**

The Company operates in one segment, industrial instrumentation. The Company’s chief operating decision maker, the Chief Executive Officer, evaluates the performance of the Company and makes operating decisions based on financial data consistent with the presentation in the accompanying financial statements.

In addition, the CEO reviews the following information on revenues by product category:

	Three months ended September 30,		Nine months ended September 30,	
	2006	2005	2006	2005
Gas detection devices	\$ 1,138,143	\$ 1,421,706	\$ 4,063,177	\$ 3,744,060
Environment controllers	654,848	256,930	1,229,010	952,341
FieldServers	913,759	526,119	2,571,485	1,725,432
	<u>\$ 2,706,750</u>	<u>\$ 2,204,755</u>	<u>\$ 7,863,672</u>	<u>\$ 6,421,833</u>

### **Line-of-Credit**

As of September 30, 2006, the Company has an outstanding balance of \$100,000 on its line of credit. The Company is in compliance at September 30, 2006 with covenants required by the line of credit.

### **Stock Options**

The shareholders of the Company approved the 2006 Stock Plan on May 16, 2006. Under the plan 111,125 shares of common stock were reserved for employee stock options. The 2006 Stock Plan also provides for unissued options from the 1996 Stock Plan to be credited to the pool of shares available for issuance under the 2006 Stock Plan. At September 30, 2006 a total of 437,396 unissued options were credited to the 2006 Stock Plan from the 1996 Stock Plan providing a pool balance of 548,521 options. As of September 30, 2006, no options had been granted under the 2006 Stock Plan.

No 1996 Stock Plan options were granted during the three and nine month periods ended September 30, 2006 and 2005. A total of 6,979 stock options were exercised by employees for cash proceeds of \$3,238 during the three month period ended September 30, 2006, while 500 options expired during the same period. A total of 50,000 options were exercised by employees for cash proceeds of \$11,000 during the three month period ended September 30, 2005, while a total of 325,000 options expired during the same period.

### **Subsequent Events**

Options to acquire 20,500 shares of the Company's restricted common stock were granted under the 1996 Stock Plan at a meeting of the Board of Directors on October 23, 2006. The ten year term options, which vest over five years, were issued to non-management employees at an exercise price of \$1.30 per share. The estimated grant-date fair value of such options approximated \$1.30 per share.

*This Form 10-QSB and any accompanying letter to shareholders contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934. Statements that are not statements of historical fact may be deemed to be forward-looking statements. The words “believe,” “expect,” “intend,” “plan,” “project,” “will,” and similar words and phrases as they relate to the Company also identify forward-looking statements. Such statements reflect the current views and assumptions of the Company and are not guarantees of future performance. These statements are subject to various risks and uncertainties. The Company’s actual results could differ materially from those anticipated in these forward-looking statements as a result of the risk factors described in this Form 10-QSB, including those under the heading “Certain Factors That May Affect Future Results” and those issues described under the heading “Critical Accounting Policies.” The Company expressly disclaims any obligation to release publicly any updates or revisions to any forward-looking statement to reflect any changes in expectations, or any change in events or circumstances on which those statements are based, unless otherwise required by law.*

## ITEM 2: MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### Results of Operations

For the three months ended September 30, 2006, Sierra Monitor Corporation reported net sales of \$2,706,751 compared to \$2,204,755 for the three months ended September 30, 2005. For the nine month period ended September 30, 2006, net sales were \$7,863,672 compared with \$6,421,833 in the prior year nine-month period. The sales results for the three and nine month periods ended September 30, 2006 represent increases of 23% in both periods, compared to the same periods in 2005.

In the third quarter of 2006, sales of our gas detection products were approximately \$1,138,000 compared to \$1,422,000 in the third quarter of 2005. For the nine month period ended September 30, 2006, our gas detection product sales were approximately \$4,063,000 compared to \$3,744,000 in the same period in 2005. These results represent a 20% year over year decrease in the third quarter and a 9% year over year increase in the year-to-date period. Although shipments of large gas detection systems declined in the third quarter of 2006 compared to the third quarter of 2005, our gas detection product sales have increased steadily in the nine month period of 2006.

Sales of Environment Controllers to the telecommunications industry in the third quarter of 2006 were approximately \$655,000 compared to \$257,000 in the third quarter of 2005. In the nine month period ended September 30, 2006 sales of Environment Controllers were approximately \$1,229,000 compared to \$952,000 in the same period in 2005. The higher level of sales in both the three and nine month periods of 2006 are due, in part, to a single, one-time, large order to replace aging monitors in one telephone company’s remote underground communications sites.

In the third quarter of 2006, sales of FieldServer products, our communications bridges, were approximately \$914,000 compared to \$526,000 in the same period in 2005. In the nine month period ended September 30, 2006, sales of FieldServers were approximately \$2,571,000 compared to \$1,725,000 sales reported in the same period in 2005. The sales results for the three and nine month periods ended September 30, 2006 represent increases of 74% and 49% respectively compared to the same periods in 2005. FieldServer revenue includes sales of our ProtoCessor products that offer the features of the FieldServer in a small module for use by original equipment manufacturers. As a new product group, ProtoCessor shipments were not significant in the first nine months of 2005. In the three and nine month periods ended September 30, 2006, ProtoCessor sales represent approximately 12 % of FieldServer revenues. In addition to increases in ProtoCessor sales, we continue to experience broader

acceptance of FieldServers by building automation integration companies resulting in repeat sales to existing customers and increased numbers of FieldServers used in each construction project.

Gross profit of \$1,688,383 for the three month period ended September 30, 2006 was 62% of sales compared to \$1,301,513, or 59% of sales, in the same period in the previous year. The gross profit for the nine month period ended September 30, 2006 was \$4,774,818, or 60% of sales, compared to \$3,798,060, or 59% of sales, in the same period in the previous year. The improvement in gross margins for both the three and nine month periods ended September 30, 2006 compared to the same periods in 2005 is due, primarily, to the change in product mix. FieldServer products have higher software content than gas detection products and hence a higher margin level. The higher percentage of FieldServer sales contributes to higher overall gross margins.

Expenses for research and development, which include new product development and engineering to sustain existing products, were \$466,990, or 17% of sales, for the three month period ended September 30, 2006 compared to \$433,109, or 20% of sales, in the comparable period in 2005. In the nine month periods ended September 30, 2006 and September 30, 2005, research and development expenses were \$1,336,351, or 17% of sales, and \$1,288,441, or 20% of sales, respectively. Although there is no significant change in the overall level of spending for engineering, development work has been refocused toward gas detection product development and ProtoCessor engineering.

Selling and marketing expenses, which consist primarily of salaries, commissions and promotional expenses were \$562,855, or 21% of sales for the three month period ended September 30, 2006, compared to \$553,801 or 25% of sales, in the comparable period in the prior year. For the nine month periods ended September 30, 2006 and September 30, 2005, selling and marketing expenses were \$1,860,360, or 24% of sales, and \$2,011,833, or 31% of sales, respectively. Lower salary and benefit expenses as a result of our reduction in the number of sales managers during the second half of 2005 were partially offset by higher commissions and training costs for independent sales representatives. Independent sales representatives are compensated for sales of gas detection equipment and systems by commissions expensed at the time of shipment.

General and administrative expenses, which consist primarily of salary expenses, building rent and insurance expenses, were \$311,945 or 12% of sales, for the three month period ended September 30, 2006 compared to \$302,474, or 14% of sales, in the three month period ended September 30, 2005. For the nine month periods ended September 30, 2006 and September 30, 2005, general and administrative expenses were \$998,662, or 13% of sales, and \$960,064, or 15% of sales, respectively. The increase in general and administrative expenses is, in part, due to higher salary and benefit expenses and also due to higher legal fees related to deposition taken of management in a third party lawsuit in which the company was not named and other professional fees.

In the three month period ended September 30, 2006 our income from operations was \$342,889 compared to \$10,810 in the three month period ended September 30, 2005. In the nine month period ended September 30, 2006, our income from operations was \$567,016 compared to a loss of \$463,597 in the nine month period ended September 30, 2005. The improvement in income in the year to date nine month period is \$1,030,613 compared to the same period in 2005. The improvement in operating income is the result of our 22% increase in revenue of \$1,441,839 combined with improved gross margins and lower selling and marketing expenses

After interest and tax expenses, our net income for the three-month period ended September 30, 2006 was \$206,087 compared to \$6,485 in the same period of 2005. For the nine month period ended September 30, 2006, our net income was \$340,209 compared to net loss of \$278,158 in the same period of 2005.

## **Liquidity and Capital Resources**

Working capital was approximately \$3,263,000 at September 30, 2006, an increase of approximately \$554,000 from December 31, 2005. Our accounts receivable have increased approximately \$575,000 as a result of higher monthly sales. Our normal collection cycle experience is less than sixty days. Inventories have increased approximately \$450,000. Inventories increase as we support higher levels of sales but they have also increased to support anticipated sales levels for new products including ProtoCessor and new gas detection modules. Increases in current liabilities of approximately \$200,000 include tax payable and general accounts payable. Cash has decreased by approximately \$322,000. Accounts receivable, inventories, and cash are the primary components of our working capital.

Management believes that its present resources, including cash and accounts receivable, are sufficient to fund its anticipated level of operations through at least the next twelve months.

## **Certain Factors That May Affect Future Results**

The Company's future operating results may be affected by a number of factors, including general economic conditions in both foreign and domestic markets, cyclical factors affecting our industry, lack of growth in our end-markets, and our ability to develop, manufacture, and sell both new and existing products at a profitable yet competitive price.

The industry in which we compete is highly competitive and we expect such competition to continue in the future. Most of our competitors are larger than our company and have substantially greater financial, technical, marketing and manufacturing resources. While we have invested in new products, there can be no assurance that we can continue to introduce new products on a timely basis or that some of our products will not be rendered non-competitive or obsolete by our competitors.

Our operations are concentrated in a single building in Milpitas, California. Our operations could be interrupted by fire, earthquake, power loss, telecommunications failure and other events beyond our control. We do not have a detailed disaster recovery plan. In addition, we do not carry sufficient business interruption insurance to compensate us for losses that may occur and any losses or damages incurred by us could have a material adverse effect on our business.

Our short-term liquidity is dependent upon our ability to reduce collection cycles, reduce inventories and manage expenses and cash distribution. We must also maintain our compliance with the conditions of our bank line of credit.

## **Critical Accounting Policies**

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires management to make judgments, assumptions and estimates that affect the amounts reported in the Company's consolidated financial statements and the accompanying notes. The amounts of assets and liabilities reported on our balance sheets and the amounts of revenues and expenses reported for each of our fiscal periods are affected by estimates and assumptions, which are used for, but not limited to, the accounting for revenue recognition, accounts receivable, doubtful accounts and inventories. Actual results could differ from these estimates. The following critical accounting policies are significantly affected by judgments, assumptions and estimates used in the preparation of the consolidated financial statements:

### **a) Revenue Recognition**

The Company recognizes revenues in accordance with Staff Accounting Bulletin ("SAB") No. 104, "Revenue Recognition," when all of the following conditions exist: a) persuasive evidence of an arrangement exists in the form of an accepted purchase order; b) delivery has occurred, based on

shipping terms, or services have been rendered; c) the Company's price to the buyer is fixed or determinable, as documented on the accepted purchase order; and d) collectibility is reasonably assured. By product and service type, revenues are recognized when the following specific conditions are met:

#### Gas Detection and Environment Control Products

Gas Detection and Environment Control products are sold as off-the-shelf products with prices fixed at the time of order. Orders delivered to the Company by phone, fax, mail or email are considered valid purchase orders and once accepted by the Company are deemed to be the final understanding between us and our customer as to the specific nature and terms of the agreed-upon sale transaction. Products are shipped and are considered delivered when (a) for FOB factory orders they leave our shipping dock or (b) for FOB customer dock orders upon confirmation of delivery. The creditworthiness of customers is generally assessed prior to the Company accepting a customer's first order. Additionally, international customers and customers who have developed a history of payment problems are generally required to prepay or pay through a letter-of-credit.

#### Gas Detection and Environment Control Services

Gas Detection and Environment Control Services consist of field service orders (technical support) and training, which are provided separate from product orders. Orders are accepted in the same forms as discussed for Gas Detection and Environment Control Products above with hourly prices fixed at the time of order. Revenue recognition occurs only when the service activity is completed. Such services are provided to current and prior customers, and, as noted above, creditworthiness has generally already been assessed. In cases where the probability of receiving payment is low, a credit card number is collected for immediate processing.

#### FieldServer Products

FieldServer products are sold in the same manner as Gas Detection and Environment Control products (as discussed above) except that the products contain embedded software, which is integral to the operation of the device. The software embedded in FieldServer products includes two items: (a) a compiled program containing (i) the basic operating system for FieldServers, which is common to every unit, and (ii) the correct set of protocol drivers based on the customer order (see FieldServer Services below for more information); and (b) a configuration file that identifies and links each data point as identified by the customer. The Company does not deem the hardware, operating systems with protocol drivers and configuration files to be separate units of accounting, as defined in EITF 00-21, "Revenue Arrangements with Multiple Deliverables," because the Company does not believe that they have value on a stand-alone basis. The hardware is useless without the software, and the software is only intended to be used in FieldServer hardware. Additionally, the software included in each sale is deemed to not require significant production, modification or customization, as described in Statement of Position (SOP) 97-02, "Software Revenue Recognition", as amended, and therefore the Company recognizes revenues upon the shipment or delivery of products (depending on shipping terms), as described in Gas Detection and Environment Control Products above.

#### FieldServer Services

FieldServer services consist of orders for custom development of protocol drivers. Generally customers place orders for FieldServer products concurrently with their order for protocol drivers. However if custom development of the protocol driver is required, the product order is not processed until development of the protocol driver is complete. Orders are received in the same manner as described in *FieldServer Products* above, but due to the non-recurring engineering aspect of the

customized driver development the Company is more likely to have a written evidence trail of a quotation and a hard copy order. The driver development involves further research after receipt of order, preparation of a scope document to be approved by the customer and then engineering time to write, test and release the driver program. When development of the driver is complete the customer is notified and can proceed with a FieldServer product (see FieldServer Products above). Revenues for driver development are billed and recognized upon shipment or delivery of the related product that includes the developed protocol drivers (as noted in FieldServer Products above). Collectibility is reasonably assured as described in FieldServer Products above.

#### Discounts and Allowances

Discounts are applied at time of order entry and sales are processed at net pricing. No allowances are offered to customers.

#### **b) Accounts Receivable and Related Allowances**

Our domestic sales are generally made on an open account basis unless specific experience or knowledge of the customer's potential inability or unwillingness to meet the payment terms dictate secured payments. Our international sales are generally made based on secure payments including cash wire advance payments and letters of credit. International sales are made on open account terms where sufficient historical experience justifies the credit risks involved. In many of our larger sales, the customers are frequently construction contractors who are in need of our field services to complete their work and obtain payment. Management's ability to manage the credit terms and take advantage of the leverage provided by the clients' need for our services is critical to the effective application of credit terms and minimization of accounts receivable losses.

We maintain an allowance for doubtful accounts which is analyzed on a periodic basis to insure that it is adequate. We believe that we have demonstrated the ability to make reasonable and reliable estimates of allowances for doubtful accounts based on significant historical experience.

#### **c) Inventories**

Inventories are stated at the lower of cost or estimated market, with cost being determined on the first-in, first-out method. The Company uses an Enterprise Requirements Planning ("ERP") software system which provides data upon which management can rely to determine inventory trends and identify excesses. The carrying value of inventory is reduced to market for slow moving and obsolete items based on historical experience and current product demand. We evaluate the carrying value of inventory quarterly. The adequacy of these carrying amounts is dependent upon management's ability to forecast demands accurately, manage product changes efficiently, and interpret the data provided by the ERP system.

#### **d) Off Balance Sheet Arrangements**

As of September 30, 2006 the Company had no off-balance sheet arrangements as defined in Item 303(c) of the Securities and Exchange Commission's Regulation S-B.

### ITEM 3: CONTROLS AND PROCEDURES

*Evaluation of disclosure controls and procedures.* Our management evaluated, with the participation of Gordon R. Arnold, our principal executive and financial officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-QSB. Based on this evaluation, Mr. Arnold has concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms.

*Changes in internal control over financial reporting.* There was no change in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-QSB that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## **PART II: OTHER INFORMATION**

### Item 6. Exhibits

<u>Exhibit Number</u>	<u>Description</u>
3.1 <sup>(1)</sup>	Articles of Incorporation of the Registrant.
3.2 <sup>(2)</sup>	Bylaws of the Registrant.
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

- (1) Incorporated by reference to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 1989.
- (2) Incorporated by reference to the Company's Quarterly Report on Form 10-QSB (File No. 000-07441) filed with the SEC on August 14, 1998.

### **SIGNATURES**

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**SIERRA MONITOR CORPORATION**  
Registrant

Date: November 7, 2006

By: /s/ Gordon R. Arnold  
Gordon R. Arnold  
President  
Chief Executive Officer  
Chief Financial Officer

## Index to Exhibits

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**CERTIFICATION OF CHIEF EXECUTIVE OFFICER**

I, Gordon R. Arnold, the Chief Executive Officer of Sierra Monitor Corporation certify that:

1. I have reviewed this quarterly report on Form 10-QSB of Sierra Monitor Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the small business issuer as of, and for, the periods presented in this report;
4. The small business issuer's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the small business issuer and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the small business issuer, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the small business issuer's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. Disclosed in this report any change in the small business issuer's internal control over financial reporting that occurred during the small business issuer's most recent fiscal quarter (the small business issuer's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the small business issuer's internal control over financial reporting; and
5. The small business issuer's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the small business issuer's auditors and the audit committee of the small business issuer's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the small business issuer's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the small business issuer's internal control over financial reporting.

Date: November 7, 2006

By: /s/ Gordon R. Arnold  
Gordon R. Arnold  
Chief Executive Officer

**CERTIFICATION OF CHIEF FINANCIAL OFFICER**

I, Gordon R. Arnold, the Chief Financial Officer of Sierra Monitor Corporation certify that:

1. I have reviewed this quarterly report on Form 10-QSB of Sierra Monitor Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the small business issuer as of, and for, the periods presented in this report;
4. The small business issuer's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the small business issuer and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the small business issuer, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the small business issuer's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. Disclosed in this report any change in the small business issuer's internal control over financial reporting that occurred during the small business issuer's most recent fiscal quarter (the small business issuer's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the small business issuer's internal control over financial reporting; and
5. The small business issuer's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the small business issuer's auditors and the audit committee of the small business issuer's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the small business issuer's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the small business issuer's internal control over financial reporting.

Date: November 7, 2006

By: /s/ Gordon R. Arnold  
Gordon R. Arnold  
Chief Financial Officer

**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

I, Gordon R. Arnold, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the quarterly report of Sierra Monitor Corporation on Form 10-QSB for the quarterly period ended September 30, 2006 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such quarterly report on Form 10-QSB fairly presents, in all material respects, the financial condition and results of operations of Sierra Monitor Corporation.

Date: November 7, 2006

By: /s/ Gordon R. Arnold  
Gordon R. Arnold  
Chief Executive Officer  
Chief Financial Officer