

ITRONICS INC  
Form 10KSB  
April 17, 2007

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549  
FORM 10-KSB

(Mark One)

ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the fiscal year ended **December 31, 2006**

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the Transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 33-18582

**ITRONICS INC.**

(Name of small business issuer in its charter)

**Texas**

**75-2198369**

(State or other jurisdiction of (I.R.S. Employer Identification Number)  
incorporation or organization)

**6490 South McCarran Boulevard, Building C, Suite 23 Reno, Nevada**

**89509**

(Address of Principal Executive Offices) Zip Code

Issuer's telephone number: **(775) 689-7696**

Securities registered under Section 12(b) of the Exchange Act:

Title of each class                      Name of each exchange on  
which registered

None

None

Securities registered under Section 12(g) of the Exchange Act:

None

(Title of class)

Check whether the issuer is not required to file reports pursuant Section 13 or 15(d) of the Exchange Act. ( )

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 ( )

Check if disclosure of delinquent filers in response to Item 405 of Regulation S-B is not contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. (x)

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

State issuer's revenues for its most recent fiscal year: \$1,884,412.

The aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the average bid and asked price of such common equity, as of March 31, 2007, was \$7,256,768.

As of March 31, 2007 there were issued and outstanding 368,705,921 shares of the Registrant's Common Stock.

DOCUMENTS INCORPORATED BY REFERENCE

None

Transitional Small Business Disclosure Format (Check one): Yes ( ) No (X)

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ITRONICS INC. AND SUBSIDIARIES

2006 FORM 10-KSB ANNUAL REPORT

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**ITEM 1.**

DESCRIPTION OF BUSINESS.

**INTRODUCTION**

We are the inventor and developer of the "Beneficial Use Photochemical, Silver, and Water Recycling" technology that produces environmentally beneficial GOLD'n GRO fertilizers and silver bullion.

We are an environmental process technology company that has developed what we believe is a unique technology for photochemical recycling. We, through our subsidiary, Itronics Metallurgical, Inc., extract more than 99% of the silver and virtually all of the other toxic heavy metals from used photoliquids and use this "Beneficial Use Photochemical, Silver and Water Recycling" technology to produce environmentally beneficial chelated liquid fertilizer sold under the trademark GOLD n GRO, animal repellent/fertilizer to be sold under the trademark GOLD n GRO Guardian, and silver bullion. We also provide development planning and technical services to the mining industry.

**OUR PRODUCTS AND SERVICES**

We currently operate the following two business segments under separate wholly owned subsidiaries:

GOLD n GRO Fertilizer: This segment, known as Itronics Metallurgical, Inc., operates a fertilizer manufacturing, photochemical recycling, and silver refining facility. Revenues are generated by photochemical management services, sales of photochemical concentrators, sales of silver, and sales of GOLD n GRO liquid fertilizer products.

Mining Technical Services

: This segment, known as Whitney & Whitney, Inc. (WWI), provides mineral project planning and technical services to the mining industry. It has specialized knowledge in all aspects of mineral project development and has been deeply involved in gold mine development for more than 25 years. It employs technical specialists with expertise in the areas of mining, geology, mining engineering, mineral economics, material processing, and technology development. Technical services have been provided to many of the leading U.S. and foreign mining companies, several public utilities with mineral interests, to various state agencies, the U.S. and foreign governments, and the United Nations and the World Bank. WWI was under contract with the Country of Bolivia from 1986 through early 1992 to assist it in developing its mining industry. In 2005 WWI launched an internet website to provide gold mining company profiles to the interested public.

We have three wholly owned subsidiaries, Whitney & Whitney, Inc. ("WWI"), Itronics Metallurgical, Inc. ("IMI"), and Itronics California, Inc. (ICI), a 92.5% owned partnership, Nevada Hydrometallurgical Project ("NHP"), and an 82.53% owned joint venture, American Hydromet. A brief description of each organization follows:

Itronics Metallurgical, Inc.

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IMI was established in 1981 to manage the metallurgical and materials processing operations being developed under WWI and American Hydromet research and development programs. IMI has been the main provider of management services to American Hydromet since 1986. IMI is now managing the photochemical/GOLD'n GRO fertilizer segment as discussed below.

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Nevada Hydrometallurgical Project

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Nevada Hydrometallurgical Project ("NHP") is a research and development partnership formed in 1981 to fund research into potential commercial applications for certain hydrometallurgical process techniques developed by the U.S. Bureau of Mines Research Center in Reno, Nevada between 1970 and 1979. A number of potential commercial applications were defined by NHP, one of which is the American Hydromet silver/gold refining technique. In late 1985, NHP assigned its interest in the silver/gold refining technique to American Hydromet. NHP retained its proprietary interest in the other potential commercial applications for future developments. NHP continues as a financing and technology owning partnership. We own 92.5% of NHP.

American Hydromet

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American Hydromet is a Nevada joint venture that was formed in 1985 to develop certain silver and gold refining/recovery technology and to create business based upon such technology. The GOLD n GRO fertilizer segment now being managed by IMI is owned by American Hydromet. The ownership interests in American Hydromet are: NHP for 76.5%, IMI for 1%, and American Gold & Silver Limited Partnership ("AG&S") for 22.5%. AG&S is a Nevada limited partnership, for which WWI serves as the general partner and owns a general and limited partnership interest totaling 11%. We own a 37% limited partnership interest in AG&S. In total, we own approximately 83% of American Hydromet.

Itronics California, Inc.

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Itronics California, Inc. (ICI) was acquired in March 1999 by Itronics Metallurgical, Inc. ICI, originally named PD West, Inc., was acquired for its phosphoric acid recycling technology. ICI has no business operations but plans are to utilize the phosphoric acid technology and may eventually operate IMI's photochemical services and GOLD'n GRO fertilizer business in California.

Whitney & Whitney, Inc.

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WWI was incorporated in 1977. WWI was primarily a mineral consulting firm that provided planning and technical services to the mining industry. WWI is now further developing an internet website originally launched in 2005 to provide gold mining industry data to the investing public, while maintaining a presence in the technical consulting field.

**SUMMARY HISTORY OF OPERATIONS**

Whitney & Whitney, Inc. was established to provide a wide range of technical services to the mining industry. During the 1980's, WWI completed several multi-client fertilizer marketing studies. Also during this time period, WWI was contacted by state and local environmental officials concerning the problem of photographic wastes, laden with silver and other toxic heavy metals, being dumped in local sewer systems.

Over the years, the mining technical services business was highly cyclical, closely following the base and precious metals industries, and specifically, the price of copper, other base metals and gold. This condition pointed out the necessity of expanding our business into new industries. When considering the fertilizer marketing studies previously performed, along with the growing national issue of sewer system contamination from toxic photowastes and silver toxicity to fish, it seemed to be a natural extension of WWI's existing expertise to expand

into the photowaste recycling business. In 1987 the decision was made to move forward with research and development of a process to extract silver from photographic liquid wastes. It took until 1997 to develop and demonstrate a satisfactory fertilizer and to complete university testing to demonstrate its agronomic viability.

In March 1998 IMI signed a five year definitive licensing, manufacturing, and distribution agreement with Western Farm Service, Inc. (WFS), one of the largest liquid fertilizer bulk retailers in the western United States. The agreement was renewed in March 2003 for another five years, subject to annual cancellation provisions. The agreement grants WFS an exclusive license and right to manufacture and market IMI's GOLD'n GRO line of bulk liquid fertilizer products for the Turf & Ornamental and Specialty Agricultural markets in the states of Arizona, California, Hawaii, Idaho, Oregon, and Washington. WFS has approximately 90 agricultural retail outlets in these states. In the discussion below, and elsewhere in this report, we refer to this group of retail outlets as our licensed distributor network.

A 35,000 square foot manufacturing plant in Reno/Stead, Nevada was purchased in 1999. Construction of the liquid processing area was completed in early 2000, and a "shake-out" period was completed in which small batches of photochemicals were processed and small batches of fertilizer were manufactured. By late 2000 the new facility had demonstrated the ability to "demetallize" the received photo liquids to required EPA levels, thereby proving the technical viability of the new technology on a commercial scale. By the first quarter of 2001 we were positioned to develop sales for more than a dozen liquid fertilizer products.

In 2001, at the request of our licensed distributor, we developed a chelated liquid micronutrient zinc fertilizer with the objective of selling the product in truckload quantities. This fertilizer development was successful and provided the basis for the first tank truck load sales in the fourth quarter of 2001. During 2002 this new bulk liquid fertilizer was successfully introduced into the distributor network. During 2002 work on a bulk liquid GOLD'n GRO fertilizer that could be used as a "base liquid" in the distributor's proprietary field blends was commenced. In 2003 development work on a second chelated liquid micronutrient zinc product for bulk sale was initiated. Field testing of both new bulk liquid fertilizers was conducted during 2003 and in late 2003 they were approved for introduction into the distributor sales network for 2004.

During the same 2001 to 2003 period, more than two dozen liquid fertilizer formulations were evaluated for suitability and market potential. By the end of 2003, product line development had been completed, and 13 fertilizers covering two categories have been established: chelated liquid multinutrient fertilizers and chelated liquid micronutrient fertilizers. The fertilizers are sold both to the general public and through licensed and non-licensed distributors. Product improvement and new product development will continue, but our focus since 2005 is primarily on GOLD'n GRO Liquid Fertilizer sales expansion and on expansion of the services business as needed to support increasing GOLD'n GRO fertilizer sales.

We are developing an animal repellent/fertilizer that will be sold under the trademark GOLD'n GRO Guardian. This product will use one of the GOLD'n GRO multi-nutrient liquid fertilizers as a base liquid, which has the property of being taken into the plant as a fertilizer and imparting odor and taste characteristics that are offensive to deer and other animals, such as

rabbits, that eat plants. The GOLD'n GRO Guardian product was field tested during 2003 and was subsequently approved for use by the North American Deer Management Network. GOLD'n GRO Guardian is a repellent fertilizer product and must be registered under both the pesticide regulations and the fertilizer regulations for each state in which it will be sold. The product must also be registered with the Federal EPA as a biopesticide. Introduction of this product for commercial sales will be delayed until the registrations are completed. In 2005 we acquired the interest in the GOLD n GRO Guardian trademark, product rights, and the repelling product formula owned by Mr. Howland Green. We now own 100% of all rights related to GOLD n GRO Guardian. Mr. Green has become one of our directors and is Northeast Manager for GOLD n GRO Sales Development. Substantial funding over the next twelve months will be required to complete the EPA and California registration process.

During the period 1999 through 2003 we developed a "low temperature vacuum distillation" machine that operates at room temperature and is able to remove up to 80% of the water from photochemical solutions without damaging the chemicals, producing a high silver content concentrate that can be shipped as a commercial product in inter-state commerce. The distilled water is clean enough for re-use on site and the reduction in volume of material needing to be shipped produces an 80 percent reduction in transportation cost making shipment possible anywhere in the United States. These machines are being sold under the trademark "Itronics Metallurgical Photochemical Silver Concentrators".

After we began producing fertilizer, we noted that the by products of the process were the main materials needed to manufacture glass and ceramic. Therefore we began research and development of glass and tile formulations. During 2003, the first pieces of glass/ceramic tile were produced. With the successful development of a glass/ceramic tile product, we achieve the ability to recycle 100 percent of the materials received from customers, including waste that is generated internally during processing. The silver refining technology and the glass/ceramic tile products development efforts are being expanded in parallel with expansion of GOLD'n GRO fertilizer sales.

A more detailed discussion of our business, based on our two business segments described above, follows.

## GOLD n GRO FERTILIZER

### Operations

We operate a commercial scale plant to receive used photochemical liquids, recover the silver and other metals, and convert the demetallized solutions to liquid GOLD'n GRO fertilizer products. A critical component of this integrated manufacturing system is to match, within a reasonable range, the incoming volume of photochemical liquids with the utilization of those liquids in fertilizer or other manufactured products.

Photochemical services operates as a regional business in northern Nevada, serving more than 200 customers in the northern Nevada market. A satellite service operation has been established in the San Francisco Bay Area which is a large market with at least three strong competitors. We believe we are able to compete effectively based upon pricing and service quality. In October 2006 we began servicing a large company in northern Nevada and in November 2006 we began servicing a large company in the San Francisco Bay Area.

Growth of silver bullion output is driven by photochemical processing to support GOLD'n GRO

fertilizer sales. There are some opportunities to expand silver output separate from photochemical recycling, but profit margins for the refining services are very small when compared to the inventory requirements and the security risk. Because of these factors, gold and silver refining services are limited to categories of materials where our proprietary

technology can be used and that offer better profit margins than conventional precious metal refining. We will be actively looking at opportunities to expand this segment in future years.

Spent photochemical liquids received from customers are logged and recorded, then tested for silver content and contaminants. We achieve high contaminant control standards by working proactively with our regular customers. Once testing is completed, the photographic solutions are available for processing.

### Growth Plans and Implementation

With the successful completion of the initial pioneering development work by the GOLD 'n GRO Fertilizer Division, we are implementing growth plans that are expected to drive expansion well into the future. The status of these plans and their implementation is described below.

Our manufacturing plant is presently configured to produce 1.2 million gallons (on a single shift basis) of GOLD 'n GRO fertilizer annually (about 5,700 tons) and can be expanded to produce 7.2 million gallons of GOLD'n GRO per year, or about 36,000 tons. GOLD'n GRO fertilizer production in 2006 utilized about 5 percent of planned capacity. Planned expansions to achieve the 36,000 ton volume include increasing both dry raw material and liquid storage, increasing tank truck loading capacity, and automation of certain manufacturing functions. Expansion can be achieved incrementally as fertilizer sales continue to grow.

We have developed the following eight-part approach to growth:

1. Increase sales in the established market segments.
2. Develop GOLD'n GRO fertilizer applications for more crops.
3. Expand sales to new territories.
4. Expand the GOLD'n GRO specialty fertilizer product line.
5. Complete development of and commercialize the new glass/tile products.
6. Develop and commercialize environmentally friendly metal leaching reagents for recovery of silver, gold, and other metals.
7. Continue facilities expansion and technology development.
8. Acquire established companies and/or their technologies.

Plans and status of implementing each of the growth categories is explained in more detail in the following sections.

#### 1. Increase sales in established market segments.

We are selling into or developing applications for the three major segments. These are:

- a. Specialty Agriculture which includes Avocados, Citrus, Grapes, Fruit and Nut Trees, and Vegetables.
- b. Bulk Field Crops which include alfalfa, cereal grains, corn, cotton, and soybeans.



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c. The Urban Market, which includes Home Lawn and Garden, Landscape Construction and Maintenance, and Nursery and Greenhouse markets, and Golf Courses.

Our primary focus is to increase bulk GOLD n GRO liquid fertilizer sales as rapidly as possible. This is being achieved by expanding sales in the Specialty Agriculture segment and in the Bulk Field Crops segment. There are on-going small package sales in the Urban Market, but these are small relative to the other two segments.

2. Develop GOLD'n GRO fertilizer applications for more crops.

Based on our experience to date, it takes approximately two to five years to develop a new fertilizer product, which includes regulatory approval. It typically takes another two to four years to achieve market acceptance of successful products, which includes field trials to demonstrate product effectiveness.

We are performing field trials in Idaho, Oregon, and Washington for applications on onions, potatoes, and winter wheat. We also have begun field trials in Rhode Island for lawn, landscape, and nursery application and have started several new trials in California for silage corn applications.

A GOLD'n GRO base liquid nutrition program is being marketed. The program is called the "Gallon and a Quart" or "4 to 1" program. It calls for one gallon of GOLD n GRO base liquid for each quart of GOLD'n GRO chelated micro-nutrient used in soil applications. Field demonstrations have shown improved nutrition uptake and crop output under this cost effective program. Marketing of this program is expected to produce substantial increases in the tonnage of GOLD'n GRO fertilizer sales.

In 2006 we began contributing to an ongoing Zinc Nutrition Research Program at Utah State University in Logan, Utah. To date, the research has demonstrated the effectiveness of GOLD n GRO 9-0-1+7% Zinc as a chelated liquid zinc micronutrient fertilizer for zinc deficient corn. Results include preventing visual symptoms of zinc deficiency, significantly increased tissue concentration of zinc compared to untreated plants, and doubled dry mass.

3. Expand sales to new territories.

The GOLD'n GRO products are being sold in Arizona, California, Colorado, Idaho, Nevada, Oregon, Rhode Island, Washington, and Utah, with the majority of our sales in central California. We completed registration of select GOLD n GRO fertilizers in Idaho, Oregon and Washington in 2005 and in Utah in 2006; sales development is now underway. Two GOLD'n GRO products are registered in seven northeastern states and all of the products are registered in New York and in New Jersey. Based on our experience, commercial sales can be generated approximately one to two years after introductory sales activities are initiated. We are in the process of identifying distributors for New York and the other seven northeastern states. Each new geographic area developed will require the same procedural approach.

The expansion into the Northwest states of Idaho, Oregon, Washington, and Utah is being managed by one field agronomist. The cost of maintaining that position ranges from \$120,000 to \$150,000 per year. The expansion into the Northeast states is being managed by one part time person at an annual cost of approximately \$30,000. That person is also the lead person in seeking

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customers for our Photochemical Silver Concentrators. We plan to increase these spending levels in 2007, depending

on sales support requirements.

In general, expansion to new regions of the country will require at least one field agronomist for each new region at a cost similar to that for the Northwest region. In addition, each state has varying registration requirements for product labels and costs of registration. Development of product labels is done internally using existing staff. Registration fees for each state vary widely, ranging from \$25 to \$600 per year, largely depending on how many products are registered in the particular state. For the near term, we anticipate utilizing present staff and management for corporate support of the sales efforts for both existing regions and for the new regions. For the longer term, as we expand we will need to add corporate support personnel. In 2006 we added a Ph.D. agronomist, to support GOLD n GRO sales efforts.

Our plan to expand sales in Urban Markets requires the consumer to utilize fertilizer injection equipment. This equipment provides economical, easy use of liquid fertilizers for consumer lawns and gardens. We added two types of fertilizer injectors to our "e" store, which is the first step into this market. Additionally, other fertilizer injectors are already available to consumers through irrigation supply stores.

#### 4. Expand the GOLD'n GRO specialty fertilizer product line.

We are developing two new specialty products, a calcium plus magnesium fertilizer named GOLD n GRO 11-0-0+5% Ca (Calcium) and a high magnesium content fertilizer named GOLD n GRO 8-0-0+3% Mg (Magnesium), both targeting foliar and soil application. We have registered GOLD n GRO 11-0-0+5% Ca in Nevada and California. Sales development started in the second quarter of 2006. The registration of GOLD n GRO 8-0-0+3% Mg is planned for the second quarter of 2007 at which time sales development will be started.

We are developing a new category of repellent fertilizers that are expected to be sold at higher profit margins than our other products. The GOLD n GRO Guardian deer repellent fertilizer is an example of this type of specialty fertilizer. The U.S. market for deer repellents is believed to exceed \$50 million in annual sales. Products currently in the market have limited effectiveness so we believe that there is a real opportunity for a line of systemic products that are effective for several weeks after each application. GOLD'n GRO Guardian small plot tests have shown effectiveness for 8 to 12 weeks as well as excellent wintertime effectiveness.

We acquired ownership interest in the GOLD n GRO Guardian trademark, product rights, and the repelling product in 2005. We now own 100% of all rights related to GOLD n GRO Guardian. Results of the research of the GOLD n GRO Guardian deer repellent fertilizer has provided a basis for a bird (goose) repellent fertilizer that will be perfected for small plot field trials and registration after the registration of GOLD n GRO Guardian is underway. Currently, this product line is strictly for non-food plant applications. We have engaged consultants experienced in the EPA registration process. We are presently working with them to plan the process and lab work needed to complete the registration.

We believe the users of the GOLD n GRO deer repellent fertilizer will be upscale homeowners, commercial landscapers, and municipal facilities, and wholesale and retail nurseries. The initial sales center will be in Rhode Island.

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#### 5. Complete development of and commercialize glass/tile products.

In 2003, we developed and produced glass /tile products proving that the product concept is technically viable. When the development of the glass/ceramic tile product is completed, we will achieve the ability to recycle 100 percent of the photoliquid materials received from customers, including waste that is generated internally during fertilizer production. We have completed preliminary market research for the tile markets, but expect to do much more work to develop a plan to enter this market.

6. Develop and commercialize metal leaching reagents for recovery of silver, gold, and other metals.

We are developing applications of our technology to extract silver from photoliquids to the mining sector. This work is being expanded and a small pilot circuit will be established to chemically process certain categories of silver-bearing solid wastes. The gold mining sector currently uses cyanide and other toxic chemicals in their leaching process. We believe it may be possible to create and adapt new non-toxic leaching reagents and leaching procedures for processing other secondary materials and certain types of mine generated products. The specific markets for leaching reagents in gold and silver mining is large and world wide, but has not yet been studied in detail for market development. Our Technical Services Division maintains an extensive library and database of mines and mining activities worldwide, which provides us ready access to market information as we need it. Much pilot plant work, including one or more field pilot operations, must be completed before quantitative market studies can be completed.

7. Continue facilities expansion and technology development.

As fertilizer sales volume increases, we will need to increase tank truck loading capacity. With the introduction of additional bulk products and increased demand for our products, load out capacity for shipment of three more bulk products is needed. The first phase, construction of a containment area, was substantially completed in late 2006. While we believe that we can handle expected growth in 2007 with the existing load-out module, we hope to complete construction on the new load out equipment during the second half of 2007, subject to the availability of financing.

8. Acquire established companies and/or their technologies.

To enhance our operations and market presence, we intend to acquire small established companies or their technologies. In 2005, we completed our acquisition of the GOLD n GRO Guardian technology. Further acquisitions will depend on the potential benefits and suitable financing.

Competition

Our GOLD n GRO fertilizer products compete with well established fertilizer companies that have significantly more capital with which to market their products. Our competitors include large companies such as Scotts Miracle-GRO, Dow AgroSciences Company, Uniroyal Chemical Corporation, and smaller companies such as Pursell Technologies, Inc. We believe that our fertilizers compete primarily on the basis of product quality and performance.

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Our photochemical recycling fees are generated primarily from removing used photochemicals from our customer's sites. We compete for these customers with large national firms like Safety Kleen and Philips Environmental but our primary competitors are smaller regional firms. In 2006 we made a decision to offer wholesale processing services to these established service companies in order to more rapidly expand photochemical supplies.

We sell our silver bullion to a commercial refiner under standard industry terms. We are a very small producer of silver; consequently the refiner will purchase all the silver we can presently produce. For several years, there has been a global shortage in the supply side of the silver market. Our ability to sell our silver bullion could only be impacted if there were a dramatic contraction in the demand for silver, and only then if we grow to be a much larger silver producer than we are now.

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Markets

## Fertilizer

The total fertilizer market consists of the "Agricultural Market" and the "Urban Market". The Urban Market accounts for at least \$9 billion in annual sales in the United States. The "Specialty Ag" segment of the Agricultural Market is a \$5 billion segment making the total a \$14 billion market. Substantially all of our present GOLD 'n GRO fertilizer sales are in the "Specialty Ag" segment.

More than 50 million tons of fertilizer products are sold annually in the United States. This includes almost 20 million tons of multi-nutrient fertilizers and almost 3.5 million tons of secondary nutrient and micro-nutrient products. About 38 percent of the total usage is as fluid fertilizers. Our 2006 sales represent less than 0.04 percent of the specialty ag segment of the fertilizer market.

Our GOLD'n GRO fertilizers are all liquid. There are major differences in manufacturing, distribution, and sale of liquid fertilizers as compared to dry fertilizers. Basic differences are described here so that the investor can better understand the technology, logistics, and application of liquid fertilizers and thereby gain a better understanding for the market niche that we are entering.

Liquid fertilizer technology is more complex than dry technology. Typically dry solids can be readily blended into dry mixtures that can then be bagged, or transported as dry bulk powders. In contrast, liquid fertilizers are reacted products and must be manufactured using precise recipes so that the final product will remain stable. Dry products can be stored for years without degradation, whereas liquid products typically have a limited storage life ranging from a few days for proprietary field blends, up to 4 years or longer for certain types. Liquid fertilizers can also freeze over a rather wide range of temperatures, a problem not encountered with dry fertilizers. Because of these technical factors, bringing a line of liquid fertilizers to market is much more complex than bringing a line of dry products to market.

Dry fertilizers are typically applied with dry spreaders. Liquids are sprayed on with tank sprayers or aircraft, injected into the soil using special applicators, or applied through irrigation systems using sprinklers, micro-sprinklers, or drip irrigation. Liquid fertilizers

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can also be applied with ditch irrigation by running the fertilizer into the water at controlled rates. The use of irrigation water to apply the liquid fertilizers is called fertigation.

Dry fertilizer packaging and transport is typically simpler and less costly than liquid fertilizer packaging and transport. Bulk liquids must be moved in tank trucks or tank rail cars and stored in large bulk tanks at distribution points. The distributors who sell the liquids to farmers must install and operate tank farms and maintain a fleet of specialized applicators. Distribution and application of liquid fertilizers typically requires specialized technical knowledge related to mixing and handling as compared to the use of dry fertilizers. Liquid fertilizers are typically easier and less costly to apply when irrigation is available, and availability of the fertilizer nutrients in the soil for uptake by crops is greater when liquid fertilizers are used. Use of fertigation to apply liquid fertilizers can reduce tractor trips through the fields, reducing cost and also reducing soil compaction. Because of less cost for application and improved availability of the liquid nutrients to the plants, liquid fertilizers in the United States are continuing to gain market share. Use of liquid starter mixes for dry land crops is also expanding, especially for planting field crops such as cotton, corn, soybeans, and wheat.

Only certain fertilizer distribution companies have specialized in marketing liquid fertilizers and have the facilities and equipment required to sell, deliver, and apply the liquid fertilizers. Our licensed distributor is such a company.

The GOLD'n GRO fertilizers are complex and represent a new category of liquid nutrition technology. The GOLD'n GRO fertilizers contain bulk chelating agents that conventional liquid fertilizers do not contain. The chelating agents,

which are normally quite costly, are supplied as components of the starting photographic liquids. The chelating agents improve the availability of micronutrient metals such as zinc, iron, manganese, and the secondary nutrients calcium, and magnesium. The photoliquids also have a natural content of sulfur, the other important secondary nutrient. These chelate enriched multinutrient characteristics distinguish the GOLD'n GRO liquids from other liquid fertilizers and are the main reason why the GOLD'n GRO liquid fertilizers represent a new type of nutrient technology.

The animal repellent/fertilizer market is a new market for us. The users of this product will be upscale homeowners and commercial and municipal facilities, and commercial nurseries. The deer population is growing rapidly in the northeastern U.S. and so the center of gravity for this product is the northeastern seaboard states. The initial sales center will be in Rhode Island. The markets being served are the Commercial Landscape and wholesale and retail Nursery segments. The GOLD'n GRO Guardian line of products is strictly for non-food plant applications so the distribution channels are different from the channels being developed for GOLD'n GRO fertilizers.

The U.S. market for deer repellents is believed to be well in excess of \$50 million per year. Products currently in the market are believed to have limited effectiveness so we believe that an opportunity exists for a line of systemic products that are effective for several weeks after each application. The GOLD'n GRO Guardian is demonstrating effectiveness for periods of 8 to 12 weeks, and may be able to provide "year round" protection. We are pursuing development of this line of products as rapidly as possible.

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### Photochemical Recycling

We estimate that there are more than 1,500 generators of photographic hazardous waste in the State of Nevada and more than 500,000 throughout the United States. This includes printed circuit board manufacturers, photo off-set printers, photographic developers, lithographers, photographers, micro-filming (banks, companies, etc.) and x-ray users (dentists, doctors, hospitals, podiatrists, orthopedic surgeons, veterinarians, radiologists and industrial x-ray users). We estimate the total annual market for recycling this category of waste to be in the range of \$400 to \$500 million.

We are aware of digital imaging and its impact on usage of conventional photography. The impact is different for each of the major segments; medical, color photography, and printing/microfiche. Digital imaging has made significant inroads into printing/microfiche processing with an almost 85% reduction in volume of photographic liquids over the past ten years. Over the last several years, it became clear to us that contrary to popular belief, digital photography is creating a new source of photowastes from Internet companies that combine digital imaging services with the ability to print high quality photographs for their customers. Digital methods are being adopted in the medical industry, and although the medical sector is relatively high growth with the aging U.S. population, digital imaging has had the effect of slowing the growth of waste photo liquids being generated and may lead to a decline in future years.

A larger impact on photo waste generation has been the pressure for companies to reduce the amount of waste generated at the operating sites. In photography, water was used in copious quantities for film rinsing and large quantities of low chemical content waste liquids were generated. With the tightening of regulation of discharge of contaminated waters the equipment manufacturers have focused on reducing water usage. This attention to reduction of waste water has contributed to a reduction in the quantities of waste liquids being generated. It is expected that efficiency of use and associated waste reduction will continue, driven by increasing waste disposal costs. On-site photochemical recovery using a Photochemical Silver Concentrator and re-using the recovered water is expected to continue to become more and more attractive to photochemical waste generators.

Environmental restrictions on disposal of chemicals are continuing to tighten throughout the United States with the result that now the rate of growth for our photochemical recycling business is dependent upon the rate and vigor of fertilizer sales growth.

## Silver

Nationally, more than 50 million ounces of silver are consumed in photomaterials annually. Approximately 30% of this is lost through disposal. The Silver Institute indicates that silver usage in photography declined in 2005.

## Seasonality and Working Capital

In analyzing the market and industry competitors, it is apparent that two factors significantly impact our ability to penetrate these markets in a meaningful way. First, the seasonal aspect of fertilizer sales, which directly results in the second factor, the need for a much higher level of working capital when compared to other industries. Based on experience, we expect

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fertilizer sales to continue to have a strong seasonal component, with the primary sales season running from April through November each year, with an in-season low in July and August. In addition to the general seasonal nature of sales caused by normal weather patterns, unusual weather can further affect fertilizer sales, especially in winter and spring. For example, unusually cold or wet spring seasons may delay the growing cycle of various crops for which our fertilizer products are utilized. To overcome weather related effects on fertilizer sales, we are evaluating markets in the southern areas of the United States where growing seasons are longer and, in some cases, year round.

Due to the seasonal nature of GOLD'n GRO fertilizer sales, we must increase our net working capital to a level higher than that of non-seasonal industries. For example, some of our competitors have working capital equal to their annual sales. Consequently, ongoing debt and equity funding will be required for us to grow, even after a profitable level of operations is achieved.

## Research, Development, and Technology

The majority of our research and technology is proprietary, which means it has not been patented, but is protected with strict confidentiality agreements and limited access to our research and production facilities. A U.S. patent on the silver separation process was issued in 1987 and is now expired. We made a corporate decision to not patent our research results as the cost of obtaining and defending patents is prohibitive.

We conduct field trials to gather agronomic data and to develop knowledge of how the GOLD'n GRO products work on different crops. This field testing will continue as it is the most effective method for developing the field data needed to support claims of product effectiveness for specific crops. On-going field trials of GOLD n GRO fertilizer products continue to show significant improvements in crop production and quality. The trials are providing agronomic data that is being used to develop GOLD n GRO nutrition programs for the crops being tested.

The field trials are demonstrating that the GOLD n GRO products provide both agronomic and economic benefits in the "specialty agricultural" markets. Specialty agriculture includes vegetables, cut flowers, herbs and spices, and fruits and nuts of all types. These crops are relatively high value compared to field grains such as corn, wheat, and soybeans. Field trials in 2002 on cotton and on silage corn produced positive results, opening two new large acreage crops for GOLD'n GRO application development. Alfalfa is typically considered as a "hay" or "forage" crop and is generally of low to intermediate value when compared to specialty agricultural crops, however, high nutrient content alfalfa for the dairy market often commands a significant price premium which puts it at the low end of specialty agricultural crop values.

A 3 year field trial on Valencia orange trees was carried out with oversight from a major university in southern California was completed in 2004. Three year cumulative results were analyzed and positive results were obtained. Fruit output per tree and fruit quality were both increased.

During 2003, we completed a key phase of the research project to produce formulated glass products. The research has identified three product categories: (1) a glass ceramic mixture that can be used to produce tile and other shapes suitable for glazing and commercial use; (2)

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glass formulations that can be used as "lead free" low and intermediate temperature glazes for decorative tile and the craft pottery trade; and (3) specialty boro-silicate glass formulations. The next phase of the research will focus on production of small quantities of products for evaluation and market studies and is expected to be completed over the next two to three years.

We continue to be offered the opportunity to explore the feasibility of recycling other non-photographic materials into fertilizer. We have concluded that certain acid waste streams generated by aerospace and electronics manufacturers may be able to be converted to a form that will fit "Beneficial Use" recycling into fertilizer in association with the processed photochemical materials.

#### Environment and Regulation

All chemistry has a "cradle to grave" regulatory life span. This term means under Federal law, the prime generator has the ultimate liability for all generated waste as long as it exists. For example, conventional services, through storing and hauling, relocate the waste to a legal landfill or dispose it to sewer. Liability then remains for the cost of cleanup if the landfill has to be reclaimed or the contamination of groundwater develops.

However, once the spent chemistry reaches our facility and has been processed, the generator's hazardous waste liability is eliminated. Using our process, virtually all metals, including most of the iron, are removed. The end result leaves us with a non-hazardous "toxic-metal-free" liquid which is legal for use in high quality GOLD n GRO liquid fertilizers.

While in general our business has benefited substantially from increased governmental regulation of hazardous disposal by private industry, the waste management and recycling industry itself has become subject to extensive, costly and evolving regulation by federal, state and local authorities. We make a continuing effort to anticipate regulatory, political and legal developments that might affect our operations, but may not always be able to do so. We cannot predict the extent to which any legislation or regulation may affect future operations.

In particular, the regulatory process requires firms in our industry to obtain and retain numerous governmental permits to conduct various aspects of their operations, any of which permits may be subject to revocation, modification or denial. We are not in a position at the present time to assess the extent of the impact of such potential changes in governmental policies and attitudes on the permitting process.

For several years we have been studying the various regulatory requirements under RCRA and have been working with state and local environmental officials regarding the extent to which hazardous waste regulations apply to our operations. Through this process, we reached the conclusion that due to use of photochemicals as a beneficial ingredient in our fertilizer products, the photochemicals are not "hazardous waste" as defined in the regulations, and therefore, beneficial materials that are otherwise regulated as hazardous waste, are exempt from most of such regulations. In early 1996 we received concurrence from State of Nevada environmental officials that our photochemical fertilizer process meets the existing RCRA requirements for exemption from all environmental regulation with the exception that certain presently conducted lab analyses of the photochemicals will continue to be required. Certain of our large scale customers presently meet the exemption requirements. Present levels of

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fertilizer sales utilize all the photochemicals received. Once sales of all the photochemical materials are well established in the fertilizer or other commercial products, all our Nevada customers will be exempt from the regulations, including hazardous material transport/manifest rules. We believe that this exemption applies nationwide. Therefore, we intend to pursue similar concurrence from environmental officials in all applicable states, so that all our customers will be recognized as exempt from the RCRA regulations.

Environmental regulation of photowaste generators has strengthened over the last several years, and that trend is expected to continue. In the past year, heavy metal contamination of fertilizers has become a significant issue in California and other parts of the country. Public concern over this issue is expected to intensify. We believe that the GOLD n GRO line of fertilizer products is uniquely suited to alleviating this environmental concern and that we are well positioned to meet future environmental needs.

#### Permits and Inspections

To the best of our knowledge, we have obtained permits from all governmental agencies having jurisdiction, such as the U.S. EPA, Nevada Department of Environmental Protection, Washoe County Health Department and the City of Reno, Nevada. We are not required to obtain federal permits, but are required to have, and have obtained, local permits for our photochemical recycling facility under the provisions of the U.S. EPA. Similar permits will be required of all facilities that we may construct. Our recycling facility is subject to frequent inspections and to regulations (including certain requirements pursuant to federal statutes) which may govern operating procedures for land, water and air pollution, among other matters. In particular, our operations are subject to the Safe Drinking Water Act, TSCA (Toxic Substances Control Act-pursuant to which the EPA has promulgated regulations concerning the disposal of PCBs), the Clean Water Act (which regulates the discharge of pollutants into surface waters and sewers by municipal, industrial and other sources) and the Clean Air Act (which regulates emissions into the air of certain potentially harmful substances). Employee safety and health standards under the Occupational Safety and Health Act are also applicable to our employees.

## MINING TECHNICAL SERVICES

### Services offered

Our Mining Technical Services segment offers a wide range of technical services to the mining industry, including management support, mineral project development, ore reserve and material balance reviews, expert assistance in contract dispute or litigation, and mineral economics and cost studies

### Operations

The Mining Technical Services Division originally provided typical consulting services to the mining industry which required high level technical personnel, including our President, devoted to each project. To reduce our dependence on our President to generate new consulting contracts, while better utilizing our core professional staff, the division is being reconfigured to focus most of its efforts on a global Internet Information Portal "insidemetals.com". The information portal operates 24 hours per day 7 days per week anywhere in the world where computers and the Internet are available. Anyone with access to the Internet anywhere in the world can subscribe to the service at any time using their credit card to pay the subscription fee.



We launched the insidemetals.com website in 2005, targeting the companies and individuals interested in the mining and precious metals industry. The website will generate revenue by charging a subscription fee for monthly access to the site. Currently, the site contains an array of information about gold mining and companies in the gold industry. We intend to add information on other mineral sectors gradually over time. A program to solicit advertising customers is being developed and is being offered to gold exploration companies. To assist with the sales development program of the website, we hired a manager of marketing and sales in October 2006. He is responsible for marketing efforts for both the insidemetals.com website and for technical consulting services to the mining industry.

### Expansion Plans

In 1999 WWI initiated a long term R&D project to replace the use of cyanide in the extraction of metals from silver/gold and gold/copper ores. The new thiosulfate leaching technology being developed under this program utilizes the same technology as our proprietary photochemical recycling process. The project, called Itronics Thiomet, may seek to establish operating joint ventures at specific mine sites to apply the thiosulfate leaching technology. This project is on hold pending further commercial development of fertilizer sales.

In 2004 a project to establish a subscription based gold industry and gold company Internet publication was begun. The web publication, called "insidemetals.com", provides the customer with gold industry and producing gold company financial, production, and ore profiles. Initially, the companies to be profiled are in the Gold Company sector, which includes gold, silver, platinum, and palladium producers. The profiled companies are publicly traded on the New York and American Stock Exchanges and on NASDAQ. The publication was launched in August 2005 and the target market includes gold company employees, governmental agencies, both domestic and foreign, and individual investors interested in the gold markets. In addition to providing subscription revenue, it is anticipated that the publication will enhance our opportunity to obtain new sources for technical consulting work. This subscription based Internet Information Portal provides an opportunity for relatively unrestricted growth by being available to a diverse global base of potential customers.

We anticipate that mining company professionals, all government agencies with minerals related responsibilities, financial industry investment professionals, and individual investors who have an interest in investing in mining companies but who have limited mineral industry knowledge will benefit from this Information Portal. The market scope for this service is global and is accessible with a "click of a mouse" in all countries of the world through the

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Internet. Whitney & Whitney, Inc. has contacts throughout the world and expects that the good will generated over a period of more than 25 years will provide market support for this service.

### Competition

Our consulting services are generally in the area of management support and mineral economics. Management support projects include advice on mineral development strategies, audits of ore reserves and appraisals on mineral properties primarily to mining companies. Our projects tend to be short term, generally less than one year, and are typically sole sourced to us based on the reputation of our president. Other companies that provide similar services include local and regional mineral consulting firms.

Our competition for the Internet Information Portal is other websites that provide gold and other precious metal information to the interested public.

ITEM 2.

DESCRIPTION OF PROPERTY.

I. FACILITIES.

Itronics leases approximately 3,000 square feet of office space at 6490 South McCarran Blvd., Building C-23, Reno, Nevada. IMI leases approximately 2,000 square feet of warehouse space in Reno, Nevada. This space is being used for supply storage.

IMI owns a 35,000 square foot manufacturing facility in Reno-Stead, Nevada. The building contains all the equipment used for treating the used photochemicals, preparing the recovered silver for sale, and manufacturing the GOLD n GRO fertilizer products.

II. EQUIPMENT.

The equipment being used in the recycling and fertilizer manufacturing process is proprietary information. However, the plant for recycling liquid photochemicals into fertilizer is a fairly typical chemical process facility consisting of appropriate arrangement of tanks and pumps. Solids produced by processing are recovered by filtration.

The refining operation consists of a material handling section, solids drying, and a melting section. The equipment arrangements are proprietary, but the main items are pumps, tanks, filtration equipment, drying ovens, and the melting furnaces.

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ITEM 3.

LEGAL PROCEEDINGS.

As of December 31, 2006 we have accrued for liabilities, including interest, of \$589,508 which relate to various lawsuits and claims for the collection of the funds due. These include 15 leases totaling \$432,616 (reflected in Capital Lease Obligations) plus \$47,235 in additional interest (reflected in Accrued Interest) and two trade payables totaling \$87,206 (reflected in Accounts Payable) plus \$22,451 in additional interest (reflected in Accrued Interest). The

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leases are individually secured by specified equipment.

The accrued interest noted above was recorded based on our assessment of three cases that are seeking \$251,522, which we believe are probable. The creditors have received judgments in these cases, but have taken no further collection action. We will continue to accrue interest until these cases are settled or paid in full.

We have a total of ten cases, that originally sought \$471,655, that we deem to have a remote possibility of incurring an additional unrecorded loss. We have negotiated payment agreements on these cases and, as of December 31, 2006, the recorded liability for these cases was \$230,835. We are current in our payments under the respective settlement agreements. Subsequent to December 31, 2006, all but two of these cases were paid off.

In addition to the above leases that are subject to litigation, there are four leases, with a recorded liability of \$200,420, that are in default. As required by U.S. Generally Accepted Accounting Principles, the principal balance of the leases that are in default have been classified as current liabilities.

Successful settlement of the above claims is dependent on future financing.

We may become involved in a lawsuit or legal proceeding at any time in the ordinary course of business. Litigation is subject to inherent uncertainties, and an unexpected adverse result may arise that may adversely affect our business. Certain lawsuits have been filed against us for collection of funds due that are delinquent, as described above. Other than as described above, we are currently not aware of any litigation pending or threatened for any reason other than collection of funds due and already recorded nor are we aware of any additional legal proceeding or claims that the Company believes will have, individually or in the aggregate, a material adverse affect on our business, financial condition or operating results.

ITEM 4.

SUBMISSION OF MATTERS TO A VOTE OF ITS SECURITY HOLDERS.

None.

PART II

ITEM 5.

MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS AND SMALL BUSINESS ISSUER PURCHASES OF EQUITY

(a). Market Information. The Company's common shares are traded on the over-the-counter market under the symbol ITRO.OB, and quoted in the National Quotation Bureau, Inc.'s "pink sheets" and on the NASD Electronic Bulletin Board. In 2003 the Company's stock began trading on the Frankfurt, Germany Stock Exchange under the symbol ITG. In March 2004 the Company's stock began trading on the Berlin Bremen Stock Exchange (Germany) under the symbol ITG.

The following table sets forth the high and low bid prices for the Company's common stock for each quarter for 2005, 2006, and through March 31, 2007.

|          | <u>High Bid</u> | <u>Low Bid</u> |
|----------|-----------------|----------------|
| 3/31/05  | \$0.13          | \$0.05         |
| 6/30/05  | \$0.08          | \$0.05         |
| 9/30/05  | \$0.09          | \$0.06         |
| 12/31/05 | \$0.07          | \$0.04         |
| 3/31/06  | \$0.08          | \$0.04         |

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|          |        |        |
|----------|--------|--------|
| 6/30/06  | \$0.05 | \$0.02 |
| 9/30/06  | \$0.04 | \$0.01 |
| 12/31/06 | \$0.02 | \$0.01 |
| 3/31/07  | \$0.03 | \$0.01 |

These quotations reflect inter-dealer prices without retail markup, markdown, or commissions, and may not represent actual transactions.

(b) On March 31, 2007 the number of record holders of the Common Shares was approximately 1,048.

(c) Dividends.

The Company has paid no dividends.

Recent Sales of Unregistered Securities

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In October 2006 we issued an aggregate of 2,500 shares of common stock valued at \$50 to John W. Whitney, our President, as compensation for services performed on our behalf in his capacity as a director of our Company for the third quarter of 2006.

In October 2006, we issued an aggregate of 119,518 shares of common stock valued at \$8,000 to Duane H. Rasmussen, our Vice President, as compensation for services performed on our behalf in his capacity as Vice President of our Company in part for the second quarter of 2005 and in part for periods in 2003 and prior.

In November 2006, we entered into a Securities Purchase Agreement with four accredited investors (the "Investors") for an aggregate amount of (i) \$500,000 in secured convertible notes, and (ii) warrants to purchase 20,000,000 shares of our common stock (the "Financing").

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The Investors received three year convertible notes (the "Notes") bearing simple interest at 6% per annum. The Notes are convertible into our common stock at a price equal to the lesser of (i) \$0.10 or (ii) 55% of the average of the lowest 3 intraday trading prices during the 20 trading day period ending one trading day before the conversion date. Further, the Investors received seven year warrants to purchase a total of 20,000,000 shares of our common stock at an exercise price of \$0.04 per share.

In December 2006, we issued an aggregate of 15,000,000 shares of common stock valued at \$250,000 to Wallstreet Direct Inc. for corporate marketing services to be performed in 2007.

We issued options to purchase an aggregate of 9,000 shares of common stock to Michael C. Horsley, our Controller, on November 1, 2006. The options are exercisable at \$0.15 per share and expire three years after grant.

We issued options to purchase an aggregate of 21,000 shares of common stock to four of our employees in November 1, 2006. The options are exercisable at \$0.15 per share and expire in three years from grant.

All of the above offerings and sales were deemed to be exempt under rule 506 of Regulation D and Section 4(2) of the Securities Act of 1933, as amended. No advertising or general solicitation was employed in offering the securities. The offerings and sales were made to a limited number of persons, all of whom were accredited investors, business associates of Itronics Inc. or executive officers of Itronics Inc., and transfer was restricted by Itronics Inc. in accordance with the requirements of the Securities Act of 1933. In addition to representations by the above-referenced persons, we have made independent determinations that all of the above-referenced persons were accredited or sophisticated investors, and that they were capable of analyzing the merits and risks of their investment, and that they understood the speculative nature of their investment. Furthermore, all of the above-referenced persons were provided with access to our Securities and Exchange Commission filings.

Except as expressly set forth above, the individuals and entities to whom we issued securities as indicated in this section of the registration statement are unaffiliated with us.

## ITEM 6.

### MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

Some of the information in this report contains forward-looking statements that involve substantial risks and uncertainties. You can identify these statements by forward-looking words such as "may," "will," "expect," "anticipate," "believe," "estimate" and "continue," or similar words. You should read statements that contain these words carefully because they:

- discuss our future expectations;
- contain projections of our future results of operations or of our financial condition; and
- state other "forward-looking" information.

We believe it is important to communicate our expectations. However, there may be events in the future that we are not able to accurately predict or over which we have no control. Our actual results and the timing of certain events could differ materially from those anticipated in these forward-looking statements.

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## General Overview

We are the inventor and developer of the "Beneficial Use Photochemical, Silver, and Water Recycling" technology that produces environmentally beneficial GOLD'n GRO fertilizers and silver bullion.

We are a process technology company that has developed what we believe is a unique technology for photochemical recycling. We, through our subsidiary, Itronics Metallurgical, Inc., extract more than 99% of the silver and virtually all of the other toxic heavy metals from used photoliquids and use this "Beneficial Use Photochemical, Silver and Water Recycling" technology to produce environmentally beneficial chelated multinutrient liquid fertilizer products sold under the trademark GOLD n GRO, animal repellent/fertilizer products to be sold under the trademark GOLD n GRO Guardian, and silver bullion. We also provide process planning and technical services to the mining industry and are operating and continuing to develop an internet website to provide gold mining company profiles to parties interested in the gold mining and precious metals industry.

Our fertilizer is sold primarily through Western Farm Service, Inc. (WFS), a wholly owned subsidiary of Agrium, Inc. (a NYSE company). Our distribution agreement with WFS gives them exclusive rights to sell our fertilizer products in

Arizona, California, Hawaii, Idaho, Oregon, and Washington, which represented 95% of our fertilizer sales in 2006 and 96% of such sales in 2005. This agreement is discussed in more detail in the Business section. Our plans to increase GOLD n GRO fertilizer sales, including plans to expand the product line, expand to more geographical regions in the U.S., enter new market segments, and add new distributors, are also discussed in more detail in the Business section.

We obtain a significant portion of our raw materials to manufacture fertilizer from used photoliquids. A byproduct of our fertilizer manufacturing process is silver. We sell three types of silver: silver bullion, 5 troy ounce 99.9% pure Silver Nevada Miner numismatic bars, and recycled film containing silver. Our processed silver bullion is sold to a commercial refiner under standard industry terms, which include pricing the silver based on published market quotes and applicable service fees. The Silver Nevada Miner bars sell to the consumer collectibles market. Recycled film is primarily X-ray film from hospitals that we sort and sell to a commercial film recycler; we are paid based on the value of contained silver, 45 to 60 days after shipment.

Our fertilizer manufacturing process uses several commodities. We separate silver from photochemicals, then we add zinc and other raw materials to the demetallized liquid to make our fertilizer formulations. Prices for fertilizer raw materials are generally increasing over time. We maintain limited quantities of these commodities and purchase them on a just in time basis. When prices of these commodities rise, we pass this cost on to our customers, so commodity price fluctuations have not had a significant impact on our results of operations.

The majority of our raw material inventory is comprised of silver in photochemical solutions. The table below indicates that silver prices were relatively stable in 2001 to 2003, then rose dramatically in 2004 through 2006. We regularly compare our weighted average cost of silver per ounce to current market prices; historically we have not had impairment losses. The average London spot price of silver per ounce is shown as follows:

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|             | <u>Year</u> |             |             |             |             |             |
|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| <u>Year</u> | <u>2001</u> | <u>2002</u> | <u>2003</u> | <u>2004</u> | <u>2005</u> | <u>2006</u> |
| Silver      | \$4.36      | \$4.60      | \$4.88      | \$6.67      | \$7.32      | \$11.55     |

We also provide consulting services to the mining industry. To supplement this business line, we recently launched an internet website. Our plans with regard to the website are discussed more fully in the Growth Plan and Implementation section below.

Critical Accounting Policies and Estimates.

The preparation of financial statements in accordance with accounting principles generally accepted in the United States requires that management make a number of assumptions and estimates that affect the reported amounts of assets, liabilities, revenues and expenses in our consolidated financial statements and accompanying notes. Management bases its estimates on historical information and assumptions believed to be reasonable. Although these estimates are based on management's best knowledge of current events and circumstances that may impact the Company in the future, actual results may differ from these estimates.

Our critical accounting policies are those that affect our financial statements materially and involve a significant level of judgment by management.

#### Revenue Recognition.

We operate two divisions: Photochemical Fertilizer and Technical Services. Within the fertilizer division, revenue is derived from three sources (1) sales of fertilizer, (2) photochemical recycling including pick up and transportation of photochemical waste and sales of Photochemical Silver Concentrators, and (3) sales of silver. Revenue from the sale of fertilizer, Photochemical Silver Concentrators, and silver is recognized in income when the goods are shipped. Returns since inception have been nominal; therefore, the Company has not established a returns allowance. Photochemical recycling fees are recognized in income after the used photochemical solution is removed from our customer sites and transported to our manufacturing facility.

Within the technical services division, revenue is derived from consulting services. Revenue is recognized in income as services are rendered. When the Company is responsible for subcontractor services and related expenses, such pass-through costs are included in both revenue and cost of revenues. Markups, if any, are included in revenues.

#### Inventory.

Inventory is carried on the balance sheet at the lower of cost or market value using the average cost valuation method. Because a large part of our inventory is silver contained in used photochemical materials and the market value of silver changes daily on the commodities market, we regularly monitor the carrying value of our silver inventory to ensure it is carried at the lower of cost or its current market value. If silver on the open market were less than our carrying value, we would write down the carrying value of our inventory by reducing

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recorded inventory and increasing cost of sales. If the amount of the write down were material, we would separately include the item in our statement of operations.

#### Convertible Debt Derivative

The fair value of the conversion feature and the prepayment penalty are estimated using the Black-Scholes option pricing model and taking a weighted average value based on various probabilities that the debt would be paid off prior to maturity at specified dates and therefore incurring the prepayment penalty. This model requires management to use significant assumptions in applying the model to estimate the fair value. As the Company's stock price is highly volatile, and the underlying debt amounts are relatively large, the valuation of the derivatives is subject to material gains and losses from period to period.

#### Recent Accounting Pronouncements

In June 2005 the Derivative Implementation Group issued *DIG's B38 and B39* to specify the accounting treatment of put or call options embedded in hybrid debt instruments. Both *DIG's* became effective for the first fiscal quarter beginning after December 15, 2005. These new standards require us to treat the prepayment option included in the terms of our callable secured convertible debt financing (Notes) as an embedded derivative. Under the guidance of FAS 133 and EITF 00-19, if there is more than one embedded derivative in a hybrid debt instrument, the embedded derivatives must be valued as a whole. We adopted this new standard effective for the first fiscal quarter of 2006. The estimated fair value of the conversion feature and the prepayment penalty were estimated using the Black-Scholes option pricing model and taking a weighted average value based on various probabilities that the debt would be paid off prior to maturity at specified dates and therefore incurring the prepayment penalty. The effect on the estimated fair value of the combined derivatives, compared to the prior year valuation method, was a reduction of \$301,511 as of

December 31, 2006.

In December 2006 the FASB staff issued *FSP EITF 00-19-2 "Accounting for Registration Payment Arrangements"* to specify the accounting treatment of contingent obligations to make future payments or otherwise transfer consideration under a registration payment arrangement. Our callable secured convertible debt includes an obligation for us to file registration statements with the Securities and Exchange Commission (SEC) to register sufficient common shares for the note holders to convert the debt into common stock frames and also obligates us to have the registration statements declared effective by the SEC. This new standard requires us to evaluate the contingent future payments under the criteria of a probable loss under FAS 5. The Company will adopt this new standard effective for the first fiscal quarter of 2007 and it has not yet determined what impact this standard will have on its financial position or results of operations.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157 ("*SFAS 157*"), "*Fair Value Measurements*," which defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS 157 does not require any new fair value measurements but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 is effective for fiscal years beginning after November 15, 2007 with earlier adoption permitted. We are currently evaluating

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the impact of SFAS 157, but do not expect the adoption of SFAS 157 to have a material impact on our consolidated financial position, results of operations or cash flows.

In July 2006, the FASB issued Financial Interpretation No. 48, "*Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109*" ("*FIN 48*"), which is a change in accounting for income taxes. FIN 48 specifies how tax benefits for uncertain tax positions are to be recognized, measured, and derecognized in financial statements; requires certain disclosures of uncertain tax matters; specifies how reserves for uncertain tax positions should be classified on the balance sheet; and provides transition and interim period guidance, among other provisions. FIN 48 is effective for fiscal years beginning after December 15, 2006. We do not expect the adoption of FIN 48 to have a material impact on our consolidated financial position, results of operations or cash flows.

In February 2006, the FASB issued Statement of Financial Accounting Standards No. 155 ("*SFAS 155*"), "*Accounting for Certain Hybrid Financial Instruments*". SFAS 155 simplifies the accounting for certain derivatives embedded in other financial instruments by allowing them to be accounted for as a whole if the holder elects to account for the whole instrument on a fair value basis. SFAS 155 is effective for all financial instruments acquired, issued or subject to a re-measurement event occurring in fiscal years beginning after September 15, 2006. Earlier adoption is permitted, provided the Company has not yet issued financial statements, including for interim periods, for that fiscal year. The Company will adopt SFAS 155 in the first quarter of 2007. We do not expect the adoption of SFAS 155 to have a material impact on our consolidated financial position, results of operations or cash flows.

#### Results of Operations

The primary factors affecting our revenue fluctuation between periods in fertilizer sales are seasonality and weather conditions. Sales are greater during the growing season, and are negatively affected by cold winter weather and rainy weather. In most of our markets there are two primary fertilization seasons, spring and fall, with spring being the stronger of the two. The spring season generally starts in March and goes through June and the fall season generally starts in September and runs into December. Adverse weather conditions delay the start of, or can significantly shorten, a growing season. Farmers do not fertilize their crops in rainy or cold weather; therefore they do not buy fertilizer; consequently, our distributor does not buy fertilizer from us. Additionally, we have experienced varying lengths of time for acceptance in the market of our new fertilizer products; farmers are inherently very slow to accept



new products so market penetration time can be lengthy. Our short history in the fertilizer market demonstrates that new products, if successful, obtain meaningful sales typically between two and four years after product launch.

The primary factors affecting the revenue fluctuation between periods in photochemical recycling revenue are our need to acquire this material for use in fertilizer production and our ability to store this material until it is needed. We have an unusual business model in that we need to sell our photowaste management services in order to acquire a raw material necessary for the production of our fertilizer products, as opposed to purchasing it from suppliers as most businesses do. Our management goal is to combine the incoming volume of photowastes with existing stored photowastes to meet the peaks in demand for fertilizer products. In the liquid fertilizer industry, the practice of both our distributor and the

ultimate consumer, the farmer, is to purchase fertilizer on a just in time basis, to minimize their storage requirements and related costs. For this same reason, we process our photowastes as needed for fertilizer production. Because of this, the need to seek new customers to expand the service side of our business is driven by fertilizer sales. There is also a seasonal factor in the consumer photography portion of our photowaste management services business, with the Christmas holiday season being the busiest, followed by the early summer, school graduation period. At present volumes of photowaste, this is not a significant factor, but it could become one as we grow.

The primary factor affecting the revenue fluctuation between periods in sales of silver bullion is our dependence on the timing of processing used photochemical wastes, which is primarily dependent on fertilizer manufacturing and related sales. Our silver in solution is separated from the photowaste materials during processing of the photowastes for use in fertilizer manufacturing. As described above, the timing of processing of photowastes is dependent on fertilizer sales, therefore sales of silver bullion is also dependent on the level of fertilizer sales. Market price changes will also contribute to silver revenue fluctuations by increasing or decreasing revenues depending on whether the silver price increases or decreases.

Comparison of the Year Ended December 31, 2006 with the Year Ended December 31, 2005

We reported consolidated revenues of \$1,884,412 for the year ended December 31, 2006, compared to \$1,360,987 for the prior year, an increase of 38%. Revenues for the GOLD n GRO Fertilizer segment increased by \$550,900, or 42%. Revenues from the Mining Technical Services segment declined \$27,500, or 49%. We reported a gross profit of \$87,700 for the year ended December 31, 2006 compared to a gross loss of \$130,000 for the year ended December 31, 2005, an improvement of \$217,700. The consolidated net loss for 2006 was \$3,809,900 or \$0.016 per share compared to a 2005 consolidated net loss of \$4,906,600 or \$0.026 per share, an improvement of \$1,096,700, or 22%.

To provide a more complete understanding of the factors contributing to the changes in revenues, operating expenses and the resultant operating loss and net loss, the discussion presented below is separated into our two operating segments.

PHOTOCHEMICAL FERTILIZER

|                         | <u>Year Ended December 31,</u> |              |
|-------------------------|--------------------------------|--------------|
|                         | <u>2006</u>                    | <u>2005</u>  |
| Revenue                 |                                |              |
| Fertilizer              | \$ 1,309,776                   | \$ 1,034,515 |
| Photochemical recycling | \$ 128,033                     | \$ 123,657   |

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|                                |               |               |
|--------------------------------|---------------|---------------|
| Silver                         | \$ 418,265    | \$ 146,972    |
| Total Segment Revenue          | \$ 1,856,074  | \$ 1,305,144  |
| Gross profit (loss)            | \$ 95,956     | \$ (116,682)  |
| Operating income (loss)        | \$(1,669,970) | \$(2,107,863) |
| Net income (loss) before taxes | \$(3,370,803) | \$(4,389,168) |

Revenues for the Photochemical Fertilizer segment totaled \$1,856,100 in 2006, compared to \$1,305,100 in 2005, an increase of \$550,900, or 42%.

Fertilizer sales were \$1,309,800 (1,746 tons) and \$1,034,500 (1,749 tons) for 2006 and 2005,

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respectively. This represents an increase of 27% in dollars and a nominal decline in tonnage. Our fertilizer product sales are presently grouped into three primary categories, Chelated Liquid Micro-nutrients, Chelated Liquid Multi-nutrients, and Chelated Secondary Nutrients. The Micro-nutrient category includes five products, which includes the two zinc products, GOLD n GRO 9-0-1+7% Zn and GOLD n GRO 9-0-2+3% Zn. These zinc products were introduced in 2001 and 2004, respectively. The Multi-nutrient category has a total of six products, which includes the GOLD n GRO 4-0-9+6.6% S Base Liquid, which was introduced in 2003. The Secondary Nutrient category includes GOLD n GRO 11-0-0+5% Ca which was introduced in 2006 and GOLD n GRO 8-0-0+3% Mg which is being registered and introduced in 2007. Sales of bulk Micro-nutrients were \$1,076,000 (1,259 tons) and \$863,400 (1,245 tons) for 2006 and 2005, respectively, an increase of 25% in dollars and 1% in tonnage. Sales of bulk Multi-nutrients were \$170,600 (479 tons) and \$156,800 (504 tons) for 2006 and 2005, respectively, an increase of 9% in dollars and a decrease of 5% in tonnage. The dollar increase in bulk Multi-nutrients are primarily attributable to increased bulk sales of the GOLD n GRO 4-0-9+6.6% Sulphur. Sales of bulk Secondary Nutrients were \$10,800 (9 tons) for 2006. The increase in total sales dollars, despite nearly identical volume, was achieved by sales price increases during 2006.

Photochemical recycling revenue was \$128,000 and \$123,700 in 2006 and 2005, respectively, an increase of 4%. Excluding the prior year sale of a Photochemical Silver Concentrator for \$42,000, photochemical recycling revenue increased 57% on increased volume of 53%. In October and November 2006 we obtained two new large scale customers. The addition of these two customers is expected to increase photochemical raw material (on an unconcentrated basis) to a level about 50% greater than the volume at the end of 2004 when our contract with Shutterfly was ended (Shutterfly supplied 65% of our 2004 photochemical raw materials).

We previously developed statistical information that more than 100 million gallons of used liquid silver-bearing photochemicals are generated in the United States annually. Using conversion ratios developed for the GOLD'n GRO fertilizers, this is enough volume to support manufacture and sale of more than 200 million gallons of liquid fertilizer products, or about 1 million tons, so we believe the raw material is available in the market to meet future manufacturing needs. Based on 2006 production usage, we estimate that current supplies of photochemical raw material in storage at our manufacturing plant, combined with ongoing receipts of material from other existing customers, is sufficient to meet fertilizer production needs through 2007, depending on fertilizer sales volumes. We anticipate that with continuing sales growth, we will need to obtain new large scale photochemical recycling customers to meet the demand.

We are in contact with both small and large photochemical generators, and are actively marketing Photochemical Silver Concentrators. The concentrators allow us to receive the raw materials needed to manufacture our fertilizer in much smaller volume, resulting in a higher content of chemicals desirable for fertilizer manufacturing, reducing the storage problems we were facing. The Photochemical Silver Concentrators are manufactured under contract by a third

party to meet the specifications of each customer. Concentrators typically sell for \$20,000 to \$200,000. By using a third party manufacturer to produce the Concentrators, we are outsourcing the fixed and variable costs that are associated with assembling them. Primarily, these are the facilities space needed to assemble the various parts and the specialized equipment and labor required for the assembly. Generally, we have self financed the production of Concentrators

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sold in the past. In the future, we anticipate that non-governmental customers will advance the funds necessary to acquire the parts and labor needed to produce the Concentrators. For our most recent governmental customer, we borrowed the funds needed to fulfill the contract from an unrelated individual. We anticipate using similar arrangements for future Concentrators sold to governmental customers.

Silver revenue was \$418,300 and \$147,000 for 2006 and 2005, respectively, an increase of \$271,300, or 185%. Sales of all silver or silver bearing products were \$399,200 (33,690 ounces) for 2006, compared to \$141,700 (18,149 ounces) for 2005. This is an increase of 182% in dollars and 86% in ounces. The increase is primarily from increased sales of processed silver bullion due to progress in making adjustments to our refining process needed to accommodate changing conditions in the recycling process

Combined cost of sales and operating expenses for the segment amounted to \$3,526,000 in 2006, compared to \$3,413,000 in 2005, an increase of 3%. Cost of sales increased approximately \$338,300, primarily due to an increase of raw material costs of \$193,700 from increased sales, \$104,200 for silver inventory reserves, and \$27,100 in increased payroll and related costs. The changes in revenues and cost of sales resulted in a 2006 gross profit of \$96,000 compared to a gross loss of \$116,700 in 2005, an improvement of \$212,600. Operating costs decreased \$225,300 due primarily to decreases of \$211,000 in sales and marketing and \$36,700 in general and administrative costs. Sales and marketing expenses decreased primarily due to reduced corporate marketing. General and administrative expenses decreased primarily due to a \$35,800 reduction in stock option compensation.

A significant portion of our silver inventory is contained in byproducts from our refining process. We have developed new procedures to more cost effectively obtain this silver and initial plans were to install the necessary equipment in 2006 and recover the majority of it during 2006. The project was delayed by the necessity of installing air purification equipment in the refinery. The air purification system was substantially completed in March 2007 and plans are now underway to determine the specifications of the equipment needed to process the byproducts and obtain the silver. We estimate there will be a two stage process of equipment installation, with the first stage to be completed in the third quarter of 2007 and the second stage to be completed in the fourth quarter of 2007. In order to determine the amount of the silver contained in these materials, we developed an estimate of recoverable silver ounces. Accordingly, we recorded a recoverability reserve of \$70,200 based on our estimate of recoverable silver at December 31, 2006. The portion of silver that we estimate will be recovered in 2008 was deemed to be slow moving inventory, and accordingly, we recorded a reserve of \$34,000.

These changes in revenues and operating expenses resulted in a segment operating loss of \$1,670,000 in 2006, compared to \$2,107,900 in 2005, a decreased loss of \$437,900 or 21%.

Other income (expense) decreased to a net expense of \$1,700,800 for 2006, compared to a net expense of \$2,281,300 in 2005, a decreased net expense of \$580,500. The primary reason for the decreased expense is a reduction of the loss on derivatives of \$908,500, which is related to the callable secured convertible debt financing obtained in July 2005 and subsequent dates. This decrease was partially offset by an increase in interest expense of \$332,100 related to the convertible debt financing.

The changes in operating loss and other expenses resulted in a segment net loss before taxes of \$3,370,800 for 2006 compared to \$4,389,200 for 2005, a decreased loss of \$1,018,400 or 23%.

### MINING TECHNICAL SERVICES

|                                | <u>Year Ended December 31,</u> |             |
|--------------------------------|--------------------------------|-------------|
|                                | <u>2006</u>                    | <u>2005</u> |
| Revenue                        | \$ 28,338                      | \$ 55,843   |
| Gross profit (loss)            | \$ (8,269)                     | \$ (13,324) |
| Operating income (Loss)        | \$(542,042)                    | \$(507,831) |
| Net income (loss) before taxes | \$(439,082)                    | \$(517,444) |

Mining technical services revenue totaled \$28,300 for 2006 compared to \$55,800 for 2005, a decrease of 49%. Included in these revenue figures are pass-through expenses of \$2,500 and \$4,900 for 2006 and 2005, respectively. Excluding these amounts, revenues amounted to \$25,800 and \$50,900 for 2006 and 2005, respectively, a decrease of 49%. The number of clients we serve and the amount of work needed by those clients varies from period to period.

On March 1, 2005 the technical services contract with Golden Phoenix Minerals, Inc.(GPXM) expired and was not renewed. Revenue from this client was \$15,000 for the two months ended February 2005.

Combined cost of sales and operating expenses totaled \$570,400 for 2006 compared to \$563,700 for 2005, a nominal increase. Research and development expense increased \$20,700. This expense is related to the development of the insidemetals.com website. The majority of this expense is an allocation of personnel costs.

In early May 2005 the technical services satellite office was closed due to the winding down of most of the technical service contracts and completion of the majority of the data gathering for the insidemetals.com project, but certain key staff members have been retained. Programming is continuing for insidemetals.com and launch of the website Information Portal occurred in August 2005. Revenues from the website have been nominal to date.

The redirection of Whitney & Whitney, Inc. to reduce emphasis on technical consulting services and to launch an internet information portal is brought about by the fact that Dr. Whitney, our President, has often been the lead person in generating new consulting contracts. Our President's increased responsibilities for managing the expanding photochemical recycling segment and overall corporate activities has reduced his time availability to actively participate in the consulting segment. Part of our objective in shifting the focus of the technical services segment is to retain our core professional staff that can provide assistance on possible future technical service contracts as well as perform administrative duties for the photochemical recycling segment, while at the same time adding a potential source of revenue that is not dependent upon labor sales and which can be managed by a professional staff. The information portal also better utilizes the Whitney & Whitney, Inc. library and information resources that are already in existence. For the years ended December 31, 2006 and 2005 we allocated costs of approximately \$206,900 and \$186,100, respectively, to the development of the web site. The site was launched in mid-August 2005 and we are now fine-tuning the general presentation and functionality of the site, as well as improving the profiled mining company information. We expect this level of spending to continue at least through the second quarter

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of 2007. As improvements to the site are completed and information maintenance becomes routine, we will adjust or redirect staff resources as needed. A program to solicit advertising customers is being developed and is being offered to gold exploration companies in the first quarter of 2007. We hired a manager of marketing and sales in October 2006. He is responsible for marketing efforts for both the insidemetals.com website and for technical consulting services to the mining industry.

The above changes in revenues and operating expenses resulted in a segment operating loss of \$542,000 for 2006, compared to \$507,800 for 2005, an increased operating loss of \$34,200 or 7%.

Other income (expense) is a net gain of \$103,000 for 2006, compared to a net expense of \$9,600 in 2005, an improvement of \$112,600. The improvement is due to an increased gain on sale of GPXM shares.

The changes in operating loss and other income resulted in a segment net loss before taxes of \$439,100 for 2006, compared to \$517,400 for 2005, a reduced loss of \$78,400, or 15%.

#### Changes in Financial Condition; Capitalization

We had a cash overdraft of \$13,800 as of December 31, 2006 compared to a cash balance of \$24,300 as of December 31, 2005. Net cash used by operations was \$1,698,200 in 2006 compared to \$2,148,500 in 2005. Operating resources utilized to finance the 2006 loss of \$3,809,900 include approximately \$185,300 in expenses paid with our common stock, \$147,700 in increased accounts payable, and \$200,000 in deferred management salaries. Cash amounting to approximately \$29,800 was invested in property and equipment in 2006, primarily for equipment in the manufacturing plant. Sales of Golden Phoenix Minerals, Inc. stock provided \$229,400 in cash from investing activities. The primary financing source of cash in 2006 was \$1,941,200 in proceeds from convertible debt, less \$247,600 in debt issuance costs.

Total assets increased from \$4,229,600 at December 31, 2005 to \$4,265,500 at December 31, 2006. Current assets increased \$78,000. The primary changes in current assets were increases in accounts receivable of \$15,300 and \$222,400 in prepaid expenses due to a \$250,000 2007 corporate marketing program paid in common stock at the end of 2006. These increases were partially offset by decreases in cash of \$24,300, marketable securities of \$91,800 due to sale of the remaining GPXM stock during 2006, and \$43,700 in inventory.

Property and equipment decreased by \$66,400 due to investment in equipment totaling \$161,600, which was offset by an increase in accumulated depreciation and amortization of \$228,000. Other assets increased \$24,300 due to an increase in deferred loan fees related to the callable secured convertible debt financing.

Total liabilities increased from \$9,703,200 at December 31, 2005 to \$11,695,000 at December 31, 2006, an increase of \$1,991,800. Of this amount, current liabilities increased \$1,876,100 and long term liabilities increased \$115,700. Due to certain terms of the Notes, the loans must be accounted for as derivative liabilities and recorded at estimated fair value at each reporting date, which was \$4,876,200 at December 31, 2006 and \$3,621,200 at December 31, 2005. The increase in the fair value of convertible debt derivatives of \$1,255,000 in 2006 was primarily due to the addition of \$2 million in Notes, offset by the conversion of \$1,266,400 in notes and

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certain changes in the assumptions used in our Black-Scholes valuation model. In addition, all outstanding non-employee warrants and options are required to be recorded as derivative liabilities at estimated fair value, which was \$380,100 at December 31, 2006 and \$134,200 at December 31, 2005. Current liabilities increased due to increases in accounts payable of \$84,100, accrued management salaries of \$200,000, interest payable to management

of \$73,900, current maturities of convertible notes and accrued interest of \$385,500, and the Notes and outstanding warrants discussed above of \$1,500,800. These increases in current liabilities were partially offset by decreases in accrued expenses of \$32,300 and current maturities of capital lease obligations of \$341,400.

In connection with the callable secured convertible debt discussed above, we registered 50 million shares in February 2006 and increased the authorized shares in March 2006 to 1 billion shares. We also completed a registration of 75 million shares in October 2006 and currently have a registration pending for 75 million shares.

#### Working Capital/Liquidity

During the year ended December 31, 2006, the working capital deficit was increased by \$1,798,100 to a deficit balance of \$10,139,600. The primary changes in working capital are the increase in callable secured convertible debt financing as discussed above. The Company has had limited cash liquidity since the third quarter of 2000. The Company has sought and obtained the funding described above, which has not been sufficient to maintain all obligations on a current basis. The cash shortage is primarily because fertilizer sales in 2006 and prior years did not expand to the extent anticipated, so operating losses were not reduced as expected. Second, the \$15 million equity line of credit agreement with Swartz Private Equities, LLC (Swartz) was not able to function to meet the Company's ongoing working capital needs and was allowed to expire on February 27, 2004. As a result, various private placements of stock with attached three year warrants were undertaken beginning in the fourth quarter of 2002. \$-0- and \$570,000 was raised from private placements during 2006 and 2005, respectively. In addition, the Company sold GPXM and other shares for net proceeds of \$229,400 and \$10,200 during the years ended December 31, 2006 and 2005, respectively, advances from an officer/stockholder were \$-0- and \$95,000 in 2006 and 2005, respectively. We obtained callable secured convertible debt financing and received proceeds of \$1,807,300 net of debt issuance costs of \$217,700 in 2005 and proceeds of \$1,693,600 net of debt issuance costs of \$247,600 in 2006. Subsequent to December 31, 2006, we received net proceeds of \$990,000 in additional callable secured convertible debt financing. We anticipate these proceeds will provide for the Company's working capital needs to May or June 2007.

We are actively working to establish a longer term financing plan that will identify capital sources for the Company's financing needs over a three to five year period. Once this plan is established, needs for financing will be adjusted and the plan will be extended annually.

#### ITEM 7.

##### FINANCIAL STATEMENTS

The response to this Item is submitted under Item 13.

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#### ITEM 8.

##### CHANGE IN AND DISAGREEMENTS WITH ACCOUNTANTS ON

##### ACCOUNTING AND FINANCIAL DISCLOSURE

To our knowledge, there is no accounting or financial disclosure dispute involving any present or former accountant.

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ITEM 8A CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures.

As of the end of the period covered by this report, we conducted an evaluation, under the supervision and with the participation of our chief executive officer and chief financial officer of our disclosure controls and procedures (as defined in Rule 13a-15(e) and Rule 15d-15(e) of the Exchange Act). Based upon this evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms.

Changes in internal controls.

There was no change in our internal controls or in other factors that could affect these controls during our last fiscal quarter or subsequent to our last evaluation that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART III

ITEM 9.

DIRECTORS, EXECUTIVE OFFICERS, CONTROL PERSONS AND CORPORATE GOVERNANCE; COMPLIANCE WITH SECTION 16(A) OF THE EXCHANGE

A. I. Directors and Executive Officers - Summary Information.

The following are the directors and executive officers of the Company:

| <u>Name</u>         | <u>Age as of</u><br><u>12/31/06</u> | <u>Position</u>  | <u>Position Held Since</u> |
|---------------------|-------------------------------------|--|----------------------------|
| Dr. John W. Whitney | 60                                  | President/Treasurer<br><br>Director                          | May 1988                   |
| Howland S. Green    | 53                                  | Northeast Manager<br><br>of GOLD n GRO sales<br><br>Director | April 2005                 |
| Gregory S. Skinner  | 52                                  | Secretary  | December 1990              |

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|                    |    |                     |               |
|--------------------|----|---------------------|---------------|
| Duane H. Rasmussen | 76 | Vice President;     | November 1997 |
|                    |    | Vice President and  | May 1994      |
|                    |    | General Manager-IMI |               |

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1) For directors, the term of office is until the next annual meeting of shareholders. For officers, the term of office is until the next annual meeting of the Board of Directors, presently scheduled to be held immediately following the annual meeting of the shareholders.

### II. Narrative Information Concerning the Directors and Executive

#### Officers of the Company.

##### John W. Whitney:

In addition to being the President and a Director of the Company, 1988 to present, Dr. Whitney is the President and a Director of each of the operating subsidiaries, Itronics Metallurgical, Inc. and Whitney & Whitney, Inc. Dr. Whitney also serves as the General Manager of American Hydromet, a joint venture.

He received his Ph.D. in Mineral Economics from Pennsylvania State University in 1976, his M.S. in Mineralogy from the University of Nebraska in 1971, and his B.S. in Geology from the University of Nebraska in 1970. Dr. Whitney has served as President of Whitney & Whitney, Inc. since its formation in 1977.

Prior to his serving as W&W full-time president, Dr. Whitney worked as a consultant for the Office of Technology Assessment, U.S. Congress, doing analysis of various Alaskan mineral issues (1977-1978), a consultant for various government agencies, including the office of Mineral Policy Analysis in the U.S. Department of Interior, and the Washington office of the U.S. Bureau of Mines, consulting firms, law firms and mining companies on a variety of mineral planning issues (1976-1977), as a consultant for BKW Associates, Inc. evaluating mining investment opportunities in Mexico and the Philippines (1973-1975), and as a geologist-mineralogist for Humble Oil & Refining Company and GeoTerrex Ltd. (1971-1972).

Dr. Whitney is an internationally recognized consultant in the field of Metal and Material Resource Economics. Dr. Whitney has presented seminars for various clients on Mining Economics, and has taught a three-credit graduate course on International Metal Economics for the University of Arizona's College of Mines. Dr. Whitney is an Honorary Faculty Member of the Academy for Metals and Materials under the seal of the American Society for Metals. Dr. Whitney has made numerous presentations and written a number of publications on various technical subjects within his broad area of expertise. Dr. Whitney is coinventor of the American Hydromet process technology and holds four patents. Dr. Whitney was selected as Nevada's Inventor of the Year for 2000 and became a member of the Inventor's Hall of Fame at the University of Nevada, Reno.

##### Howland S. Green

Mr. Green was appointed as our director and as the Northeast Manager of GOLD n GRO Sales in April 2005. He received a B.Sc. degree in plant science and landscape architecture from the University of Rhode Island in 1981. He founded the Holly Ridge Nursery in Kingston, Rhode Island in 1989 and was its owner and President until the business was sold in September 2005. He is the concept creator and a founder of the North American Deer Management Network. Mr. Green researched and developed the Mirrepep and subsequently co-developed the GOLD n



GRO Guardian systemic deer and rabbit repellents. Through his ownership of the Holly Ridge Nursery he has gained extensive knowledge of the landscape construction and maintenance and wholesale

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and retail nursery markets. He has also served as consultant to "Ask This Old House".

Gregory S. Skinner, Esq.

Mr. Skinner has served as secretary and general counsel of the Company and its subsidiaries since December 1990. He obtained his B.A. degree in Economics from the University of California at Berkeley in 1976. He obtained his J.D. degree from Hastings College of the Law, University of California at San Francisco in 1979. He is licensed to practice law in the states of California and Nevada. He retired from the practice of law on January 1, 2003 and is "of counsel" to the law office of Watson & Rounds, a Professional Corporation (WR). Prior to December 31, 2002 he was a shareholder in Skinner, Watson & Rounds, which had offices located in Reno, Las Vegas, and Incline Village, Nevada. Prior to becoming Secretary of Itronics Inc., Mr. Skinner has provided legal services and advice to Whitney & Whitney, Inc. since 1980.

Duane H. Rasmussen:

Mr. Rasmussen has served as Vice President and General Manager of IMI since May 1994. He became Vice President of the Company in November 1997. He initially joined the Company in 1991 as Assistant Manager and Business Consultant for W&W. He received his B.S. degree in Chemical Engineering from the University of Wisconsin in 1953 and his M.B.A. in Industrial Management in 1955 from the same University. He served as President of Screen Printing Systems, Inc. from 1987 to 1990 and from 1995 to October 1998. Other business experience includes approximately 20 years with Jacobs Engineering Group, Inc. in varying capacities, including Project Manager, Regional Sales Manager, Regional Vice President, and Group Vice President.

B. AUDIT COMMITTEE

At present the Company does not have an audit committee and consequently the entire Board serves as the audit committee. The Board presently consists of two members, none of whom are independent. The Company has interviewed several qualified individuals for the position of Audit Committee Financial Expert on the Board of Directors. All have declined to serve, with the primary reason being personal liability issues, especially the perceived view that being the "financial expert" increases the individual's personal exposure over that of being a regular Board member.

C. CODE OF ETHICS

The Board of Directors has adopted a Code of Business Conduct and Ethics (Code) that is applicable to the Company's directors, principal executive and financial officer, principal accounting officer or controller, and persons performing similar functions. A copy of the Code is included in this report as Exhibit 14. A copy of the Code may be obtained by anyone, without charge, by requesting a copy either by telephoning (775) 689-7696 and asking for investor relations

or by e-mailing the Company at [www.itronics.com](http://www.itronics.com). If requesting by e-mail, please indicate a preference of a reply by e-mail or by physical mail.

ITEM 10.EXECUTIVE COMPENSATION.

## Summary of Cash and Certain Other Compensation

The following table sets forth information as to the compensation of the Chief Executive Officer and the four most highly compensated officers whose compensation for the year ended December 31, 2006 exceeded \$100,000:

Summary Compensation Table:

| Name and<br>Principal  | Calendar    | Nonqualified  |                      | All Other<br>Compensation | Total        |
|--|-------------|---------------|----------------------|---------------------------|--------------|
|  |             | Compensation  | Deferred<br>Earnings |                           |              |
| <u>Position</u>  | <u>Year</u> | <u>Salary</u> | <u>Earnings</u>      | <u>Compensation</u>       | <u>Total</u> |
| Dr. John W. Whitney:<br>President, Treasurer<br>and Director (1) (2)       | 2006        | \$126,788     | \$28,310             | \$ 3,138                  | \$158,236    |
|  | 2005        | \$125,700     | \$24,716             | \$ 3,138                  | \$153,554    |
| Duane H. Rasmussen<br>Vice President, VP<br>and General Manager<br>IMI (3) | 2006        | \$132,000     | \$21,731             | -                         | \$153,731    |
|  | 2005        | \$132,000     | \$18,376             | -                         | \$150,376    |

(1) The 2006 and 2005 salary amounts include \$74,600 and \$91,400, respectively, that were not paid currently.

Dr Whitney has \$611,000 in unpaid salary as of December 31, 2006, of which \$260,000 is committed to be converted into 3,250,000 common shares. The shares will be issued when sufficient cash is available to pay required payroll tax withholdings. This unpaid salary has accumulated since July 2001 and interest at 12% per annum accrues on the unpaid balance. The interest rate is based on the rate accruing to investors on convertible debt private placements in effect in 2001. Interest earned was \$68,080 and \$59,436 for 2006 and 2005, respectively. Of the 2006 amount, \$29,464 remained unpaid at December 31, 2006. The Nonqualified Deferred Compensation Earnings amounts in the above table represent accrued interest in excess of a defined interest rate using 120% of the July 2001 federal long term applicable rate.

(2) The salary amounts listed above include \$1,788 and \$700 for 2006 and 2005, respectively, that represent

compensation paid in common stock for service as a director of the Company.

(3) The 2006 and 2005 salary amounts include \$72,500 and \$90,000 that were not paid currently.

Mr. Rasmussen has \$484,000 in unpaid salary as of December 31, 2006, of which \$168,000 is committed to be converted into 2,100,000 common shares. The shares will be issued when sufficient cash is available to pay required payroll tax withholdings. This unpaid salary has accumulated since July 2001 and interest at 12% per annum accrues on the unpaid balance. The interest rate is based on the rate accruing to investors on convertible debt private placements in effect in 2001. Interest earned was \$52,260 and \$44,190 for 2006 and 2005, respectively. Of the 2006 amount, \$31,385 remained unpaid at December 31, 2006. An additional total of \$37,430 in interest earned from July 2004 to June 2005 remains unpaid and will be paid by issuing 500,703 restricted common shares. The Nonqualified Deferred Compensation Earnings amounts in the above table represent accrued interest in excess of a defined interest rate using 120% of the July 2001 federal long term applicable rate.

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Outstanding Equity Awards at Fiscal Year-End

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| <u>Name</u>            | Number of<br>Securities   | Options at<br><u>12/31/06</u> | Option<br>Exercise<br><u>Price</u> | Option                            |
|------------------------|---------------------------|-------------------------------|------------------------------------|-----------------------------------|
|                        |                           |                               |                                    | <u>Expiration</u><br><u>Date</u>  |
|                        | Underlying<br>Unexercised | <u>Exercisable</u>            |                                    |                                   |
| Dr. John W.<br>Whitney |                           | 1,000,000                     | \$0.25                             | One year after employment<br>ends |
|                        |                           | 3,000,000                     | \$0.30                             | One year after employment<br>ends |
|                        |                           | 250,000                       | \$0.20                             | October 2007                      |
|                        |                           | 550,000                       | \$0.15                             | One year after employment<br>ends |
| Total                  |                           | 4,800,000                     |                                    |                                   |
| Duane H. Rasmussen     |                           | 425,000                       | \$0.15                             | One year after employment<br>ends |

Director Compensation:

| <u>Name</u>         | <u>Stock</u>  |              |
|---------------------|---------------|--------------|
|                     | <u>Awards</u> | <u>Total</u> |
| Dr. John W. Whitney | \$ 1,788      | \$ 1,788     |
| Paul H. Durckel (1) | \$ 4,788      | \$ 4,788     |
| Howland S. Green    | \$ 1,788      | \$ 1,788     |

(1) Mr. Durckel retired from the Board in November 2006 and was granted a \$3,000 stock bonus at that time.

The compensation plan for all directors was \$1,500 in common stock beginning with the fourth quarter of 2006 and 2,500 common shares per quarter for the quarter ending September 30, 2006 and prior quarters.

ITEM 11.

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

a) Equity Compensation Plan Information

| <u>Plan Category</u>                                       | <u>Number of securities to be issued upon exercise of outstanding options, warrants and rights</u> | <u>Weighted-average exercise price of outstanding options, warrants and rights</u> | <u>Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))</u> |
|--|--|--|--|
|  | <u>(a)</u>   | <u>(b)</u>   | <u>(c)</u>   |
| Equity compensation plans approved by security holders     | -0-  | \$-0-  | -0-  |
| Equity compensation plans not approved by security holders | 6,322,000  | \$0.241  | 2,864,917  |
| <b>Total</b>   | <b>6,322,000</b>   | <b>\$0.241</b>   | <b>2,864,917</b>   |

b) Security Ownership of Certain Beneficial Owners.

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The following table sets forth certain data with respect to those persons known to the Company, as of March 31, 2007, to be the beneficial owners of more than 5% of the outstanding shares of common stock of the Company:

Amount and Nature of Beneficial Ownership

| Name and<br>Address of<br><u>Beneficial Owner</u>                          | Common Shares                           |   | Percent<br>of<br><u>Class</u> |
|--|---|---|-------------------------------|
|  | <u>Common Shares<br/>Presently Held</u> | <u>Which May Be<br/>Acquired Within<br/>60 days</u> |                               |
| John W. Whitney<br>P.O. Box 10725<br>Reno, NV 89510<br><br>(1) (2) (3) (4) | 27,596,830                              | 8,241,250   | 35,838,080<br>9.5             |

(1) Director

(2) Officer

(3) Includes 72,768 shares owned by Maureen E. Whitney, Dr. Whitney's wife.

(4) Dr. Whitney's options include compensatory options of 1,000,000 common shares at \$0.25 per share, 3,000,000 common shares at \$0.30 per share, 250,000 common shares at \$0.20 per share, and 550,000 common shares at \$0.15 per share. The option for 250,000 common shares is exercisable at any time until October 2007 and the other options are exercisable at any time until one year after Dr. Whitney leaves the employment of the Company. The Common Shares Which May Be Acquired Within 60 Days also includes 3,250,000 shares that are to be issued to Dr. Whitney when sufficient cash is available to pay payroll tax withholdings and 191,250 common shares to be issued in connection with his service on the Board of Directors.

c) Security Ownership of Management.

The following table sets forth as of March 31, 2007, certain information, with respect to director and executive officer ownership of common stock in the Company:

Amount and Nature of Beneficial Ownership

| Name and<br>Address of | Common Shares        |   | Percent<br>of<br>Class |
|------------------------|----------------------|---|------------------------|
|                        | <u>Common Shares</u> | <u>Which May Be<br/>Acquired Within</u> |                        |

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| <u>Beneficial Owner</u>   | <u>Presently Held</u> | <u>60 days(1)</u> | <u>Total</u> | <u>(2)</u> |
|---|-----------------------|-------------------|--------------|------------|
| Dr. John W. Whitney<br>P.O. Box 10725<br>Reno, NV 89510 (3) (4) (5) | 27,596,830            | 8,241,250         | 35,838,080   | 9.5        |
| Howland S. Green<br>895 Liberty Lane<br>West Kingston, RI 02892     | 1,415,000             | 191,250           | 1,606,250    | 0.4        |
| Duane H. Rasmussen<br>P.O. Box 10725<br>Reno, NV 89510 (4)          | 2,065,473             | 2,988,203         | 5,053,676    | 1.4        |
| All directors and<br>executive officers as<br>a group (4 persons)   | 31,729,622            | 11,420,703        | 43,150,325   | 11.4       |

(1) Dr. Whitney's options include compensatory options of 1,000,000 common shares at \$0.25 per share, 3,000,000 common shares at \$0.30 per share, 250,000 common shares at \$0.20 per share, and 550,000 common shares at \$0.15 per share. The option for 250,000 common shares is exercisable at any time until October 2007 and the other options are exercisable at any time until one year after Dr. Whitney leaves the employment of the Company. The Common Shares Which May Be Acquired Within 60 Days also includes 3,250,000 shares that are to be issued to Dr. Whitney when sufficient cash is available to pay payroll tax withholdings and 191,250 common shares to be issued in connection with his service on the Board of Directors.

In April 2005 Mr. Green was granted a compensatory option to acquire 1,000,000 of the Company's restricted common shares at \$0.10 per share. The first 500,000 shares subject to the option will become exercisable when the Federal EPA accepts the registration application for the GOLD n GRO Guardian and the second 500,000 shares subject to the option will become exercisable when the Federal EPA issues the registration for the GOLD n GRO Guardian. The entire option is exercisable for two years after the EPA registration is received. This option is not included in the above table as it is not exercisable within 60 days. The Common Shares Which May Be Acquired Within 60 Days includes 191,250 common shares to be issued in connection with his service on the Board of Directors.

Mr. Rasmussen was granted a compensatory option to acquire 425,000 restricted common shares at \$0.15 per share. This option is exercisable at any time until one year after Mr. Rasmussen leaves the employment of the Company. The Common Shares Which May Be Acquired Within 60 Days also includes 2,563,203 shares that are to be issued to Mr. Rasmussen when sufficient cash is available to pay payroll tax withholdings.

(2) The percent of class is based on the sum of 368,705,921 shares outstanding as of March 31, 2007 plus, for each individual, the number of common shares as to which the named individual has the right to acquire beneficial ownership within 60 days of March 31, 2007.

(3) Director

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(4) Officer

(5) Includes 72,768 shares owned by Maureen E. Whitney, Dr. Whitney's wife.

c) Changes in Control

The Company is not aware of any arrangement which at some later date results in changes in control of the Company.

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ITEM 12.

CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE.

Advances from an officer/stockholder totaled \$161,525 at December 31, 2006 and 2005.

\$796,200 and \$594,900 of the accrued management salaries as of December 31, 2006 and 2005, respectively, is for salary in arrears due to several officer/stockholders and employee/stockholders. In addition, salary in arrears of \$514,800 and \$534,800 for 2006 and 2005, respectively, are included in stock to be issued at the respective year ends. These amounts represent the portion of salaries earned but unpaid that the officers/employees/stockholders have agreed to accept in the Company's common stock. The number of shares to be issued is 6,348,958 and 6,620,900 for 2006 and 2005, respectively. Issuance of the stock is pending sufficient cash available to pay the related federal withholding taxes. Interest expense at 12% per annum on salaries due officer and employee/stockholders amounted to \$143,478 and \$123,345, respectively, in 2006 and 2005. Of these amounts, \$-0- and \$58,272 for 2006 and 2005, respectively, were paid (or will be paid) by issuance of -0- and 765,857 shares of restricted common stock.

Interest expense on related party loans amounted to \$19,383 and \$23,948 for the years ended December 31, 2006 and 2005, respectively. Accrued interest on related party loans and accrued salaries totaled \$87,211 and \$13,276 at December 31, 2006 and 2005, respectively.

In March 1999 Dr. Whitney personally agreed to acquire up to 10,000,000 common shares of GPXM at \$0.10 per share, making him beneficial owner of more than ten percent of GPXM at that time. In March 1999, the Company's Board of Directors approved a consulting project for WWI to provide technical services to GPXM; payment was to be made in common stock, and cash. WWI completed the project in early 2005. The Company owned 556,107 shares with a market value of \$91,758 at December 31, 2005. Total revenue from GPXM for 2005 was \$15,000. The Company sold the remaining GPXM shares in 2006 and had no other transactions with GPXM during 2006.

During 2003, WWI's lease of a vehicle utilized by Dr. Whitney was completed. Dr. Whitney purchased the vehicle by financing it through a commercial lender. The purchase price was \$21,741 and the monthly payment for four years is \$531. WWI is leasing the vehicle from Dr. Whitney by making the monthly payments to the commercial lender and will acquire ownership of the vehicle when the loan is paid in full.

Director Independence

The Company had three directors who served on the Board during 2006. Dr. John W. Whitney is the President and Treasurer, and as such he is not independent. Howland S. Green serves as the Northeast Manager of GOLD n GRO sales, and as such he is not independent. Paul H. Durckel served on the Board until November 14, 2006 when he retired. Mr. Durckel had no other affiliation with the Company other than as director and consequently, he was independent.

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ITEM 13.FINANCIAL STATEMENTS AND EXHIBITSI. Index of Financial Statements and Exhibits

| <u>1. Index of Financial Statements:</u>  | <u>Page No.</u> |
|---|-----------------|
| REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM   | 42              |
| Consolidated Balance Sheets as of December 31, 2006 and 2005  | 43              |
| Consolidated Statements of Operations for the Years ended<br>December 31, 2006 and 2005                     | 45              |
| Consolidated Statements of Stockholders' Equity (Deficit)<br>for the Years ended December 31, 2006 and 2005 | 46              |
| Consolidated Statements of Cash Flows for the Years ended<br>December 31, 2006 and 2005                     | 47              |
| Notes to Consolidated Financial Statements  | 49              |
| <u>2. Index of Exhibits:</u>  |                 |
| 14 Code of Business Conduct and Ethics  | 78              |
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| 31 Rule 15d-14(a) Certification   | 80              |
| 32 Section 1350 Certification   | 84              |



STATEMENTS AND SCHEDULES

Schedules not included are omitted for the reason that they are not applicable or not required.

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders

Itronics, Inc.

We have audited the accompanying consolidated balance sheets of Itronics, Inc. and subsidiaries (the "Company") as of December 31, 2006 and 2005, and the related consolidated statements of operations, stockholders' deficit and cash flows for each of the years in the two year period ended December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company has determined that it is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes, on a test basis, examination of evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company as of December 31, 2006 and 2005, and the results of its consolidated operations and cash flows for each of the years in the two year period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As of December 31, 2006, the Company has an accumulated deficit of \$31,661,456, a negative working capital of \$10,139,616, and a stockholders' deficit balance of \$7,429,505, and is in default on various leases and loans. The Company's ability to continue as a going concern is contingent upon (a) future profitable operations and (b) the ability to generate sufficient cash to meet obligations as they become due. These conditions raise substantial doubt about the Company's ability to continue as a going concern. Management's plans regarding this matter are described in Note 14. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/CACCIAMATTA ACCOUNTANCY CORPORATION

Irvine, California

April 11, 2007

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ITRONICS INC. AND SUBSIDIARIES  
 CONSOLIDATED BALANCE SHEETS  
 DECEMBER 31, 2006 AND 2005

ASSETS

|  | <u>2006</u> | <u>2005</u> |
|--|-------------|-------------|
| CURRENT ASSETS   |             |             |
| Cash   | \$ -        | \$ 24,260   |
| Accounts receivable, less allowance for<br>doubtful accounts, 2006, \$4,600; 2005, \$7,600 | 36,493      | 21,164      |
| Marketable securities, available for sale  | -           | 91,758      |
| Inventories  | 548,399     | 592,098     |
| Prepaid expenses   | 316,872     | 94,447      |
| Total Current Assets   | 901,764     | 823,727     |
| PROPERTY AND EQUIPMENT   |             |             |
| Land   | 215,000     | 215,000     |
| Building and improvements  | 1,167,315   | 1,167,315   |
| Design and construction in progress,   |             |             |

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|   |             |             |
|---|-------------|-------------|
| manufacturing facility  | 234,347     | 153,896     |
| Equipment and furniture   | 2,543,682   | 2,302,984   |
| Vehicles  | 200,557     | 200,557     |
| Equipment under capital lease-equipment and furniture                                 | 692,438     | 851,952     |
| Equipment under capital lease-vehicles  | 21,741      | 21,741      |
|   | 5,075,080   | 4,913,445   |
| Less: Accumulated depreciation and amortization                                       | 2,131,542   | 1,903,525   |
| Total Property and Equipment  | 2,943,538   | 3,009,920   |
| OTHER ASSETS  |             |             |
| Intangibles   | 76,500      | 76,500      |
| Deferred loan fees, less accumulated amortization 2006,<br>\$328,120; 2005, \$210,357 | 335,629     | 311,362     |
| Deposits  | 8,108       | 8,108       |
| Total Other Assets  | 420,237     | 395,970     |
|   | \$4,265,539 | \$4,229,617 |

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LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)

|                             | <u>2006</u> | <u>2005</u> |
|-----------------------------|-------------|-------------|
| CURRENT LIABILITIES         |             |             |
| Bank overdraft              | \$ 13,834   | \$ -        |
| Accounts payable            | 521,188     | 437,113     |
| Accrued management salaries | 799,948     | 599,900     |
| Accrued expenses            | 206,830     | 239,130     |

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|  |            |           |
|--|------------|-----------|
| Insurance contracts payable  | 12,597     | 13,738    |
| Interest payable to officer/stockholders   | 87,211     | 13,276    |
| Interest payable, long-term debt and lease obligations   | 202,366    | 197,708   |
| Current maturities of long-term debt   | 45,065     | 57,414    |
| Current maturities of capital lease obligations  | 389,032    | 730,403   |
| Advances from stockholder  | 161,525    | 161,525   |
| Current maturities of capital lease due stockholder  | 3,333      | 5,858     |
| Current maturities of convertible notes and accrued interest   | 3,304,027  | 2,918,559 |
| Convertible debt derivatives   | 4,876,175  | 3,621,220 |
| Warrant and option liability   | 380,083    | 134,212   |
| Other  | 38,166     | 35,234    |
| Total Current Liabilities  | 11,041,380 | 9,165,290 |
| LONG-TERM LIABILITIES  |            |           |
| Long-term debt, less current maturities  | 504,131    | 534,607   |
| Capital lease obligations, less current maturities   | 149,533    | -         |
| Capital lease due stockholder, less current maturities   | -          | 3,319     |
| Total Long-Term Liabilities  | 653,664    | 537,926   |
| Commitments and Contingencies  | -          | -         |
| Total Liabilities  | 11,695,044 | 9,703,216 |
| STOCKHOLDERS' EQUITY (DEFICIT)   |            |           |
| Preferred stock, par value \$0.001 per share;<br>authorized 999,500 shares; issued and outstanding<br>2006, 0 shares; 2005, 0 shares | -          | -         |

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|  |              |              |
|--|--------------|--------------|
| Common stock, par value \$0.001 per share;       |              |              |
| authorized 1,000,000,000 shares; issued and      |              |              |
| outstanding 2006, 337,581,957; 2005, 197,148,179 | 337,582      | 197,148      |
| Additional paid-in capital                       | 23,305,788   | 21,646,307   |
| Accumulated deficit                              | (31,661,456) | (27,851,571) |
| Common stock to be issued                        | 583,868      | 573,993      |
| Accumulated other comprehensive income           | -            | (39,889)     |
| Common stock options outstanding, net            | 4,713        | 413          |
| Total Stockholders Equity (Deficit)              | (7,429,505)  | (5,473,599)  |
|  | \$ 4,265,539 | \$ 4,229,617 |

The accompanying notes are an integral part of these financial statements.

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ITRONICS INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS  
FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005

|   | <u>2006</u> | <u>2005</u> |
|---|-------------|-------------|
| REVENUES  |             |             |
| Photochemical fertilizer  | \$1,856,074 | \$1,305,144 |
| Mining technical services   | 28,338      | 55,843      |
| Total Revenues  | 1,884,412   | 1,360,987   |
| <br>COST OF REVENUES (exclusive of depreciation and<br>amortization shown separately below) |             |             |

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|   |             |             |
|---|-------------|-------------|
| Photochemical fertilizer  | 1,760,118   | 1,421,826   |
| Mining technical services   | 36,607      | 69,167      |
| Total Cost of Revenues  | 1,796,725   | 1,490,993   |
| Gross Profit (Loss) (exclusive of depreciation and amortization shown separately below) | 87,687      | (130,006)   |
| OPERATING EXPENSES  |             |             |
| Depreciation and amortization   | 228,017     | 249,125     |
| Research and development  | 293,934     | 258,711     |
| Sales and marketing   | 725,165     | 939,720     |
| Delivery and warehousing  | 108,116     | 85,963      |
| General and administrative  | 944,467     | 952,169     |
| Total Operating Expenses  | 2,299,699   | 2,485,688   |
| Operating Loss  | (2,212,012) | (2,615,694) |
| OTHER INCOME (EXPENSE)  |             |             |
| Interest  | (1,189,101) | (857,035)   |
| Loss on derivative instruments  | (541,474)   | (1,450,011) |
| Gain (loss) on sale of investments  | 97,728      | (10,116)    |
| Other   | 34,974      | 26,244      |
| Total Other Income (Expense)  | (1,597,873) | (2,290,918) |
| (Loss) before provision for income tax  | (3,809,885) | (4,906,612) |

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|   |               |               |
|---|---------------|---------------|
| Provision for income tax  | -             | -             |
| Net Loss  | (3,809,885)   | (4,906,612)   |
| Other comprehensive income  |               |               |
| Unrealized gains (losses) on securities                             | 39,889        | (30,321)      |
| Comprehensive Loss  | \$(3,769,996) | \$(4,936,933) |
| Weighted average number of shares outstanding,<br>basic and diluted | 235,294,220   | 190,031,634   |
| Loss per share, basic and diluted                                   | \$(0.016)     | \$(0.026)     |

The accompanying notes are an integral part of these financial statements

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ITRONICS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)

FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005

|                           | <u>COMMON STOCK</u>    |                                  |                        |                                       | ACCUMULATED                      |            |
|---------------------------|------------------------|----------------------------------|------------------------|---------------------------------------|----------------------------------|------------|
|                           | NUMBER<br>OF<br>SHARES | ADDITIONAL<br>PAID-IN<br>CAPITAL | ACCUMULATED<br>DEFICIT | COMMON<br>STOCK<br>TO<br>BE<br>ISSUED | OTHER<br>COMPREHENSIVE<br>INCOME |            |
|                           | <u>(1,000_s)</u>       | <u>AMOUNT</u>                    | <u>CAPITAL</u>         | <u>DEFICIT</u>                        | <u>INCOME</u>                    |            |
| Balance, Dec.<br>31, 2004 | 164,864                | \$164,864                        | \$19,438,213           | \$(22,944,959)                        | \$786,426                        | \$ (9,568) |
| Issue of<br>common stock: |                        |                                  |                        |                                       |                                  |            |
| For cash                  | 12,050                 | 12,050                           | 590,450                |                                       | (32,500)                         | -          |

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|   |         |           |              |                |           |            |
|---|---------|-----------|--------------|----------------|-----------|------------|
| For services                            | 6,003   | 6,003     | 406,323      |                | (9,933)   | -          |
| For debt conversion                     | 12,893  | 12,893    | 1,114,209    |                | (170,000) | -          |
| For asset acquisition                   | 1,338   | 1,338     | 97,112       |                | -         | -          |
| Net (loss) for the year                 |         |           |              |                |           |            |
| ended Dec. 31, 2005                     | -       | -         | -            | (4,906,612)    | -         | -          |
| Other comprehensive income for the year |         |           |              |                |           |            |
| ended Dec. 31, 2005                     | -       | -         | -            | -              | -         | (30,321)   |
| Common stock options outstanding        | -       | -         | -            | -              | -         | -          |
| Balance, Dec. 31, 2005                  | 197,148 | \$197,148 | \$21,646,307 | \$(27,851,571) | \$573,993 | \$(39,889) |
| Issue of common stock                   |         |           |              |                |           |            |
| For cash                                | 100     | 100       | 7,400        | -              | -         | -          |
| For services                            | 24,350  | 24,350    | 412,703      | -              | (3,725)   | -          |
| For debt conversion                     | 108,723 | 108,723   | 1,114,839    | -              | 13,600    | -          |
| For asset acquisition                   | 7,261   | 7,261     | 124,539      | -              | -         | -          |
| Net (loss) for the year                 |         |           |              |                |           |            |
| ended Dec. 31, 2006                     | -       | -         | -            | (3,809,885)    | -         | -          |
| Other comprehensive income for the year |         |           |              |                |           |            |



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|  |         |           |              |                |           |        |
|--|---------|-----------|--------------|----------------|-----------|--------|
| ended Dec. 31,<br>2006                 | -       | -         | -            | -              | -         | 39,889 |
| Common stock<br>options<br>outstanding | -       | -         | -            | -              | -         | -      |
| Balance, Dec.<br>31, 2006              | 337,582 | \$337,582 | \$23,305,788 | \$(31,661,456) | \$583,868 | \$-    |

The accompanying notes are an integral part of these financial statements

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ITRONICS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005

|  | <u>2006</u>   | <u>2005</u>   |
|--|---------------|---------------|
| Cash flows from operating activities         |               |               |
| Net loss                                     | \$(3,809,885) | \$(4,906,612) |
| Adjustments to reconcile net loss to         |               |               |
| <b>cash used by operating activities:</b>    |               |               |
| Depreciation and amortization                | 498,947       | 306,148       |
| Interest on convertible notes                | 581,889       | 410,593       |
| Loss on change in derivative instruments     | 541,474       | 1,450,011     |
| Inventory reserve                            | 104,161       | -             |
| Marketable securities received for services  | -             | (116,193)     |
| (Gain) loss on sale of marketable securities | (97,728)      | 10,116        |
| Addition of silver in solution inventory by  |               |               |
| offsetting photochemical processing fees     | (198,841)     | (25,005)      |
| Gain on debt forgiveness                     | (34,833)      | (24,832)      |
| Other  |               |               |

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|  |             |             |
|--|-------------|-------------|
|  | 52          | 4,713       |
| Stock option compensation                        | 4,300       | 43,379      |
| Expenses paid with issuance of common stock:     |             |             |
| Interest expense                                 | 7,483       | 58,272      |
| Consulting expenses                              | 27,840      | 282,145     |
| Director fees                                    | 3,976       | 1,850       |
| Salaries   | 145,992     | 143,673     |
| Expenses paid with issuance of debt              | -           | 30,063      |
| (Increase) decrease in:                          |             |             |
| Trade accounts receivable                        | (15,381)    | 161,528     |
| Inventories                                      | 138,379     | 4,611       |
| Prepaid expenses, deposits and other             | 8,112       | 2,061       |
| Increase (decrease) in:                          |             |             |
| Accounts payable                                 | 147,740     | (109,608)   |
| Accrued management salaries                      | 200,048     | 210,773     |
| Accrued expenses and contracts payable           | 48,084      | (86,144)    |
| Net cash used by operating activities            | (1,698,191) | (2,148,458) |
| Cash flows from investing activities:            |             |             |
| Acquisition of property and equipment            | (29,835)    | (97,962)    |
| Sale of investments                              | 229,374     | 10,177      |
| Sale of equipment                                | -           | 1,400       |
| Net cash provided (used) by investing activities | 199,539     | (86,385)    |
| Cash flows from financing activities:            |             |             |
| Proceeds from sale of stock                      | 7,500       | 570,000     |
| Proceeds from officer/stockholder advances       | 10,212      | 95,000      |

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|   |             |           |
|---|-------------|-----------|
| Proceeds from debt                        | 1,941,167   | 2,024,950 |
| Debt issuance costs                       | (247,602)   | (217,690) |
| Account receivable factoring, net         | -           | (51,229)  |
| Payments on debt                          | (250,719)   | (167,108) |
| Net cash provided by financing activities | 1,460,558   | 2,253,923 |
| Net increase (decrease) in cash           | (38,094)    | 19,080    |
| Cash, beginning of year                   | 24,260      | 5,180     |
| Cash (overdraft), end of year             | \$ (13,834) | \$ 24,260 |

The accompanying notes are an integral part of these financial statements.

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ITRONICS INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005  
(continued)

|   | <u>2006</u> | <u>2005</u> |
|---|-------------|-------------|
| Supplemental Disclosures of Cash Flow Information:              |             |             |
| Cash paid during the period for interest                        | \$232,706   | \$ 254,635  |
| Schedule of non-cash financing transactions:                    |             |             |
| Settlement of debt/accruals by issuance of common stock:        |             |             |
| Accounts payable  | -           | 11,845      |
| Convertible notes and accrued interest                          | 1,237,162   | 867,101     |
| Short-term debt and accrued interest due an officer/stockholder | -           | 90,000      |

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Acquisition of assets by issuance of common stock:

|  |         |         |
|--|---------|---------|
| Equipment  | 131,800 | 26,950  |
| GOLD n GRO Guardian product rights                 | -       | 71,500  |
| Warrants issued for debt issuance costs            | 17,595  | 12,042  |
| Amounts withheld from proceeds of debt, unrelated: |         |         |
| Prepaid interest                                   | -       | 90,000  |
| Deferred loan costs                                | 30,000  | 90,000  |
| Key man life insurance                             | -       | 20,000  |
| Short term debt and accrued interest               | -       | 143,800 |
| Accounts payable                                   | 28,833  | -       |

The accompanying notes are an integral part of these financial statements.

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### ITRONICS INC. AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2006 AND 2005

#### NOTE 1 - Summary of Significant Accounting Policies:

##### Company's Activities:

Itronics Inc., through its subsidiaries, (the Company) is involved in photochemical recycling and related silver recovery, liquid fertilizer manufacturing, and mining technical services.

##### Financial Statement Estimates and Assumptions:

The preparation of financial statements in conformity with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. For example, the Company estimates the fair value of its derivative instruments using the Black-Scholes option pricing model. As the Company's stock price is highly volatile, and the underlying debt amounts are relatively large, the valuation of the derivatives is subject to material swings from period to period. The Company measures the silver received in photochemical liquids

and estimates the amount, recoverability, and ultimate realizable value of the silver in ending inventory.

Principles of Consolidation:

The consolidated financial statements include the accounts of

Itronics Inc. and its subsidiaries:

|   | 2006              | 2005              |
|---|-------------------|-------------------|
|   | <u>PERCENTAGE</u> | <u>PERCENTAGE</u> |
| Whitney & Whitney, Inc.                           | 100.00            | 100.00            |
| Itronics Metallurgical, Inc.                      | 100.00            | 100.00            |
| Itronics California, Inc.                         | 100.00            | 100.00            |
| Nevada Hydrometallurgical Project (A Partnership) | 92.50             | 92.50             |
| American Hydromet (A Joint Venture)               | 82.53             | 82.53             |
| American Gold & Silver (A Limited Partnership)    | 47.77             | 47.77             |

Whitney & Whitney, Inc. is the general partner for American Gold & Silver. As such, the Company has control over American Gold & Silver and has included it in its consolidation.

American Gold & Silver and Nevada Hydrometallurgical Project possess no material tangible assets or liabilities.

No amount for minority interests is reflected in the consolidated balance sheets as the equity of minority interests in the net losses exceed the carrying value of the minority interests.

ITRONICS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2006 AND 2005

No amount for minority interests is reflected in the consolidated statement of operations since losses applicable to the minority interest in each subsidiary exceed the minority interest in the equity capital of each subsidiary. As a result, losses applicable to the minority interest are charged against the majority interest. When future earnings materialize, the majority interest will be credited to the extent of such losses previously absorbed.

All significant intercompany accounts and transactions have been eliminated in the consolidation.

Revenue recognition:

The Company manufactures fertilizer from used photochemical liquids. Revenues are generated in three distinct areas: (1) fees associated with removing used photochemical liquids from customer sites and sales of photochemical concentrators, (2) sales of fertilizer and (3) sales of silver. Fertilizer and silver sales are recognized when goods are shipped to our customers. Returns and allowances have been nominal. Service fees from photochemical recycling are recorded after the photochemical liquids have been picked up and transported from our customers to our manufacturing facility.

The Company provides consulting services to various entities in the mining industry. Revenue is recognized as services are delivered. When the mining technical services segment of the Company is responsible for the procurement of materials and equipment, property, or subcontracts in its consulting business, it includes such amounts in both revenues and cost of sales. The amount of such pass-through costs included in both mining consulting revenues and cost of revenues for the years ended December 31, 2006 and 2005 were \$2,547 and \$4,946, respectively. In addition, the Company periodically receives property or other payments on behalf of its clients and disburses the funds to a designated third party. When the Company has little or no risk of loss in the process, such payments are netted and not included in gross revenues or cost of revenues. Such payments amounted to \$-0- and \$94,592 for the years ended December 31, 2006 and 2005, respectively.

The Company bills its customers for its approximate costs for delivering merchandise sold to the customer. Such amounts are included in revenues. The related shipping costs are included in Delivery and Warehousing expenses in the Operating Expense section of the Consolidated Statements of Operations. Such costs were \$108,116 and \$85,963 for the years ended December 31, 2006 and 2005, respectively.

Cash and Cash Equivalents:

At present, cash includes only deposits in checking and money market accounts and does not include any cash equivalents.

Accounts Receivable Allowance Account:

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ITRONICS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2006 AND 2005

The Company uses the allowance method to account for uncollectible accounts receivable.

Marketable Securities:

The Company maintained as of December 31, 2005 investments in marketable securities, received as payment from one technical services customer. All of these equity securities were available for sale and were recorded at fair value.

The change in fair value is recorded as an unrealized gain or loss in other comprehensive income. Upon sale of the security, the company recognizes a realized gain or loss, based on specific identification of security sold. Unrealized losses are charged against net earnings when a decline in fair value is determined to be other than temporary. All of such securities were sold during 2006.

#### Inventories:

Inventory is carried on the balance sheet at the lower of cost or market value using the average cost valuation method and consists primarily of silver bearing materials, raw materials and fertilizer. Because a large part of our inventory is silver and the market price of silver changes daily on the commodities market, we regularly monitor the carrying value of our silver inventory to ensure it is carried at the lower of cost or its current market value. If silver on the open market were less than our carrying value, we would write down the carrying value of our inventory by reducing recorded inventory and increasing cost of sales. If the amount of the write down were material, we would separately include the item in our statement of operations. The raw material and work in progress balances below include \$405,631 and \$374,042 in silver bearing unprocessed photochemicals or partially processed materials as of December 31, 2006 and 2005, respectively. The Company also evaluates the recoverability of silver contained in the various raw materials and refining byproducts and estimates how long it will take to recover the estimated silver ounces contained in the materials. In 2006, the Company recorded a recoverability reserve of \$70,199 and a slow moving reserve of \$33,962. The \$104,161 reserve expense is included in Cost of Revenues in the Consolidated Statement of Operations.

Following is a summary of finished goods, work in progress, and raw materials inventories as of December 31, 2006 and 2005:

|   | <u>2006</u> | <u>2005</u> |
|---|-------------|-------------|
| Finished goods  | \$ 19,275   | \$ 53,274   |
| Work in progress  | 340,594     | 282,373     |
| Raw materials   | 292,691     | 256,451     |
|   | 652,560     | 592,098     |
| Less: Silver recoverability<br>and slow moving reserves | 104,161     | -           |
| Net Inventory   | \$548,399   | \$592,098   |

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## ITRONICS INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2006 AND 2005

#### Accounts Receivable and Inventory Factoring:

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The Company factors some of its receivables and inventory with unrelated third parties. A liability is recorded when cash is received; interest is recorded over the period the liability is outstanding. The liability and accrued interest is repaid within a day or two of when the Company is paid by the customer. Interest rates range from 2 to 3% per month, or 24 to 36% annually. Additionally, while the Company does not have any formal limits on the amounts it can factor, typically no more than \$120,000 in assets is factored at any given time. As of December 31, 2006 and 2005 all factoring arrangements were paid in full.

Property and Equipment:

Property and equipment are stated at cost. Costs associated with creating website content and graphics are capitalized under EITF 00-2, "Accounting for Web Site Development Costs." Depreciation is computed by accelerated and straight-line methods. Depreciation expense was \$182,001 and \$187,658 for the years ended December 31, 2006 and 2005, respectively. Capital lease equipment is amortized using accelerated and straight-line methods. Amortization expense on capital lease equipment was \$46,016 and \$61,283 for the years ended December 31, 2006 and 2005, respectively. Accumulated amortization on capital lease equipment is \$439,103 and \$439,977 at December 31, 2006 and 2005, respectively. Property and equipment is depreciated or amortized over the following periods. Capitalized interest on major capital projects was \$28,656 and \$-0- in 2006 and 2005, respectively.

|   |               |
|---|---------------|
| Building and improvements                             | 20 - 40 years |
| Equipment and furniture                               | 3 - 20 years  |
| Vehicles  | 5 years       |
| Equipment under capital lease-equipment and furniture | 5 - 20 years  |
| Equipment under capital lease-vehicles                | 5 years       |

Repairs and maintenance, including website maintenance and administration, are charged to operations as incurred.

Intangible Assets:

Intangible assets are amortized as follows:

|                    | <u>METHOD</u>      | <u>YEARS</u> |
|--------------------|--------------------|--------------|
| Patents            | Straight Line      | 17           |
| Deferred loan fees | Effective Interest | 3-15         |

Estimated aggregate amortization expense for the succeeding five years is:

|      |           |
|------|-----------|
| 2007 | \$144,401 |
| 2008 | 132,318   |
| 2009 | 38,029    |
| 2010 | 3,255     |



2011

3,255

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**ITRONICS INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****DECEMBER 31, 2006 AND 2005****Convertible Debt Derivatives:**

The Company has obtained callable secured convertible debt financing (Notes) in 2006 and 2005. The Notes are potentially convertible into an unlimited number of common shares. Accordingly, the Company has accounted for the Notes in accordance with SFAS 133, *Accounting for Derivative Instruments*, EITF 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*, and DIG's B38 and B39, *Embedded Derivatives: Evaluation of Net Settlement with Respect to the Settlement of a Debt Instrument through Exercise of an Embedded Put Option or Call Option* and *Embedded Derivatives: Application of Paragraph 13(b) to Call Options That Are Exercisable Only by the Debtor*, respectively, which require the beneficial conversion features and the prepayment penalties to be treated as embedded derivatives and recorded as a liability based on their relative estimated fair values. In addition, all non-employee warrants and options that are exercisable during the period that the Notes are outstanding are required to be recorded as liabilities at their fair value. The fair value of the conversion feature and the prepayment penalty are estimated using the Black-Scholes option pricing model and taking a weighted average value based on various probabilities that the debt would be paid off prior to maturity at specified dates and therefore incurring the prepayment penalty. In accordance with SFAS No. 133, *Accounting for Derivative Instruments*, the Company is required to adjust the carrying value of the derivative instruments to its fair value at each balance sheet date and recognize any change since the prior balance sheet date as a component of Other Income (Expense). These derivatives are more fully discussed in Note 4 below.

**Research and Development:**

Wages, benefits, rent, and other costs, including costs to plan and populate databases and content on our web site development costs are expensed as incurred as research and development in accordance with SFAS 2 *Accounting for Research and Development Costs*, and EITF 00-2 *Accounting for Web Site Development Costs*.

**Advertising:**

The Company advertises its products in various trade publications and general newspaper supplements. It also promotes the Company in various business publications, television, and internet media. Such advertising costs include the creative process, costs of production, and placement costs of the ads themselves. All advertising costs are expensed as incurred. Total advertising expense was \$143,760 and \$118,217 for the years ended December 31, 2006 and 2005, respectively.

## Income Taxes:

The Company has accounted for income taxes to conform to the requirements of Statements of Financial Accounting Standards (SFAS) No. 109, Accounting for Income Taxes. Under the provisions of SFAS 109, an entity recognizes deferred

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 ITRONICS INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2006 AND 2005

tax assets and liabilities for future tax consequences of events that have already been recognized in the Company's financial statements or tax returns. The measurement of deferred tax assets and liabilities is based on provisions of the enacted tax law. The effects of future changes in tax laws or rates are not anticipated. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized.

## Loss per Common Share:

Loss per common share is calculated based on the consolidated net loss for the period divided by the weighted average number of common shares outstanding during 2006 and 2005. Common stock equivalents are not included,

as their effect would be antidilutive.

Following is a reconciliation of Net Income (Loss) and Weighted average number of shares outstanding, in the computation of earnings (loss) per share (EPS) for the years ended December 31, 2006 and 2005.

|   | <u>2006</u>   | <u>2005</u>   |
|---|---------------|---------------|
| Net Loss                                      | \$(3,809,885) | \$(4,906,612) |
| Less: Preferred stock dividends               | -             | -             |
| Basic EPS loss available to                   |               |               |
| common stockholders                           | \$(3,809,885) | \$(4,906,612) |
| Weighted average number of shares outstanding | 235,294,220   | 190,031,634   |
| Common equivalent shares                      | -             | -             |
|   | 235,294,220   | 190,031,634   |
| Per share amount                              | \$(0.016)     | \$(0.026)     |

Warrants, options, and shares to be issued, totaling 661,931,877 and 175,399,421 shares as of December 31, 2006 and 2005, respectively, would dilute

EPS, and accordingly are not included in the computation of EPS.

#### Common Stock:

The Company's common shares have, subject to the provisions of any series of Preferred Stock, certain rights including one vote per share on a non-cumulative basis and a ratable portion of any dividends that may be declared by the Board of Directors. The Company may from time to time issue common shares that are restricted under Rule 144 of the Securities and Exchange Commission. Such restrictions require the shareholder to hold the shares for a minimum of one year before sale. In addition, officers, directors and more than 10% shareholders are further restricted in their ability to sell such shares.

#### Stock Based Compensation:

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## ITRONICS INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2006 AND 2005

The Company adopted the provisions of SFAS 123(R), *Share-Based Payments*, on January 1, 2006. Accordingly, compensation costs for all share-based awards to employees are measured based on the grant date fair value of those awards and recognized over the period during which the employee is required to perform service in exchange for the award (generally over the vesting period of the award). We have no awards with market or performance conditions. Effective January 1, 2006 and for all periods subsequent to that date, SFAS 123(R) supersedes our previous accounting under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"). In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 ("SAB 107") relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

The Company adopted SFAS 123(R) using the modified prospective transition method, which provides for certain changes to the method for valuing share-based compensation. The valuation provisions of SFAS 123(R) apply to new awards and to awards that are outstanding at the effective date and subsequently modified or cancelled. Estimated compensation expense for awards outstanding at the effective date will be recognized over the remaining service period using the compensation cost calculated for pro forma disclosure purposes under FASB Statement No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"). Our consolidated financial statements for the year ended December 31, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, our consolidated financial statements for prior periods were not restated to reflect, and do not include, the impact of SFAS 123(R).

Share-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Share-based compensation expense recognized in our consolidated statement of operations for the year ended December 31, 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of, December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123. For share awards granted prior to 2006, expenses are amortized under the straight-line method prescribed by SFAS 123. As share-based compensation

expense recognized in the consolidated statements of operations for the year ended December 31, 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Based on our evaluation of our present employees with unvested options, we estimated no forfeitures.

Total estimated share-based compensation expense recognized under SFAS 123R for the year ended December 31, 2006 was \$4,300 and is included in general and administrative expenses.

Through 2005, we accounted for share-based awards to employees using the intrinsic value method in accordance with APB 25 and related interpretations and provided the required pro forma disclosures of SFAS 123. Pro forma adjustments to our consolidated net loss and loss per share for the year ended December 31, 2005 were as follows

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ITRONICS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2006 AND 2005

|   | <u>2005</u>   |
|---|---------------|
| Net Loss:                                   |               |
| As reported                                 | \$(4,906,612) |
| Option compensation expense                 |               |
| As reported                                 | 43,379        |
| At fair value                               | (49,212)      |
| Pro forma Net Loss                          | \$(4,912,445) |
| Loss per share, basic and diluted           |               |
| As reported                                 | \$(0.026)     |
| Pro forma Loss per share, basic and diluted | \$(0.026)     |

The pro forma amounts were estimated for each quarter using the Black-Scholes option pricing model with the following assumptions for 2006 and 2005:

|   | <u>2006</u>       | <u>2005</u>     |
|---|-------------------|-----------------|
| Dividend yield                                      | 0%                | 0%              |
| Risk-free interest rate                             | 4.50% to 4.875%   | 3.75% to 4.375% |
| Expected life                                       | 3-10 years        | 3-10 years      |
| Expected volatility                                 | 82.09% to 102.27% | 39.0% to 83.07% |
| Weighted average exercise price granted during year | \$0.185           | \$0.103         |

Additional information about compensatory as well as non-compensatory options and warrants is presented in Note 7 below.

#### Asset Impairment:

The Company monitors conditions that may affect the carrying value of its long-lived and intangible assets when events and circumstances indicate that the carrying value of the assets may be impaired. The Company determines impairment based on the asset's ability to generate cash flow greater than the carrying value of the asset. If projected undiscounted cash flows are less than the carrying value of the asset, the asset is adjusted to its fair value.

#### Non-monetary Transactions:

The Company periodically enters into non-monetary transactions. These transactions are recorded based on the fair value of the asset, goods or services received or surrendered, whichever is more clearly evident and at such time as the earnings process is complete. When material non-monetary transactions occur, the Company discloses the transaction and basis for valuing the transaction in the period the transaction occurs. Additionally, pursuant to SFAS No. 95, "Statement of Cash Flows," the Company discloses non-cash investing and financing activities.

## ITRONICS INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2006 AND 2005

#### Contingencies:

From time to time, the Company may become party to claims against it. Management evaluates these claims as they arise as probable, reasonably possible and remote. A liability is recorded when management estimates a loss is probable. Potential costs that arise are disclosed when management believes a loss is reasonably possible and that amount can be estimated.

## Recent Accounting Pronouncements

In June 2005 the Derivative Implementation Group issued DIG s B38 and B39 to specify the accounting treatment of put or call options embedded in hybrid debt instruments. Both DIG s became effective for the first fiscal quarter beginning after December 15, 2005. These new standards require us to treat the prepayment option included in the terms of our callable secured convertible debt financing (Notes) as an embedded derivative. Under the guidance of FAS 133 and EITF 00-19, if there is more than one embedded derivative in a hybrid debt instrument, the embedded derivatives must be valued as a whole. We adopted this new standard effective for the first fiscal quarter of 2006. The estimated fair value of the conversion feature and the prepayment penalty were estimated using the Black-Scholes option pricing model and taking a weighted average value based on certain probabilities that the debt would be converted and paid off prior to maturity at specified dates.

In December 2006 the FASB staff issued *FSP EITF 00-19-2 "Accounting for Registration Payment Arrangements"* to specify the accounting treatment of contingent obligations to make future payments or otherwise transfer consideration under a registration payment arrangement. Our callable secured convertible debt includes an obligation for us to file registration statements with the Securities and Exchange Commission (SEC) to register sufficient common shares for the note holders to convert the debt into common stock frames and also obligates us to have the registration statements declared effective by the SEC. This new standard requires us to evaluate the contingent future payments under the criteria of a probable loss under FAS 5. The Company will adopt this new standard effective for the first fiscal quarter of 2007 and it has not yet determined what impact this standard will have on its financial position or results of operations.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157 ("*SFAS 157*"), "*Fair Value Measurements*," which defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS 157 does not require any new fair value measurements but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 is effective for fiscal years beginning after November 15, 2007 with earlier adoption permitted. The Company is currently evaluating the impact of SFAS 157, but does not expect the adoption of SFAS 157 to have a material impact on our consolidated financial position, results of operations or cash flows.

In July 2006, the FASB issued Financial Interpretation No. 48, "*Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109*" ("*FIN 48*"), which is a change in accounting for income

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## ITRONICS INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2006 AND 2005

taxes. FIN 48 specifies how tax benefits for uncertain tax positions are to be recognized, measured, and derecognized in financial statements; requires certain disclosures of uncertain tax matters; specifies how reserves for uncertain tax positions should be classified on the balance sheet; and provides transition and interim period guidance, among other provisions. FIN 48 is effective for fiscal years beginning after December 15, 2006. We do not expect the adoption of FIN 48 to have a material impact on our consolidated financial position, results of operations or cash flows.

In February 2006, the FASB issued Statement of Financial Accounting Standards No. 155 ("*SFAS 155*"), "*Accounting for Certain Hybrid Financial Instruments*". SFAS 155 simplifies the accounting for certain derivatives embedded in

other financial instruments by allowing them to be accounted for as a whole if the holder elects to account for the whole instrument on a fair value basis. SFAS 155 is effective for all financial instruments acquired, issued or subject to a re-measurement event occurring in fiscal years beginning after September 15, 2006. Earlier adoption is permitted, provided the Company has not yet issued financial statements, including for interim periods, for that fiscal year. The Company will adopt SFAS 155 in the first quarter of 2007. We do not expect the adoption of SFAS 155 to have a material impact on our consolidated financial position, results of operations or cash flows.

NOTE 2 - Reclassification:

The prior year's financial statements have been reclassified, where necessary, to conform with the current year presentation.

NOTE 3 - Long-Term Debt:

Long-term debt at December 31, 2006 and 2005 is comprised of the following (all debt payments are applied to outstanding interest owed at date of payment prior to being applied to the principal balance). The carrying amount approximates fair value. The fair value of long-term debt is based on current rates at which the Company could borrow funds with similar remaining maturities.

ITRONICS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2006 AND 2005

|  | <u>DECEMBER 31,</u> |             |
|--|---------------------|-------------|
|  | <u>2006</u>         | <u>2005</u> |
| <u>Notes due to unrelated parties:</u>   |                     |             |
| Notes payable secured by vehicles due at varying dates through 2006. The monthly payments total \$1,345, including interest at 10.5% to 11.0% per annum. | \$ -                | \$ 5,599    |
| Note payable secured by real property due May 2016. Monthly payment is \$6,601, including interest   |                     |             |

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|   |            |            |
|---|------------|------------|
| at 12% per annum.   | 445,653    | 469,789    |
| Financing contract secured by equipment due May 2006.   |            |            |
| Monthly payment is \$806, including interest at 17.99%  | 14,589     | 14,589     |
| City of Reno Special Assessment District for road<br>and access improvements. Payable in 40 equal semi-<br>annual payments plus interest at 6% percent per annum. | 88,954     | 92,044     |
| Unsecured note payable due in 2006. Monthly payment is<br>\$3,000, including interest at 12% per annum.   | -          | 10,000     |
| Less current portion due within one year  | (45,065)   | (57,414)   |
| Total long-term liabilities due to unrelated parties  | \$ 504,131 | \$ 534,607 |

DECEMBER 31,

2006

2005

Convertible Promissory Notes:

Three year convertible promissory notes due at  
varying dates through February 2006, including  
interest at 9% to 12% per annum. The notes and  
accrued interest are convertible into the  
Company s restricted common stock at prices  
ranging from \$0.10 to \$1.18 per share at the



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|  |              |              |
|--|--------------|--------------|
| election of the note holders.                    | \$ 1,637,000 | \$ 1,617,000 |
| Accrued interest on convertible promissory notes | 1,667,027    | 1,301,559    |
| Less current portion due within one year         | (3,304,027)  | (2,918,559)  |
| Total Long Term Convertible Promissory Notes     |              |              |
| and Accrued Interest                             | \$ -         | \$ -         |

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ITRONICS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2006 AND 2005

| <u>Callable Secured Convertible Promissory Notes:</u> | <u>DECEMBER 31,</u> |             |
|---|---------------------|-------------|
|   | <u>2006</u>         | <u>2005</u> |
| Callable secured convertible promissory notes         |                     |             |
| (more fully described in Note 4)                      | \$2,983,616         | \$2,250,000 |
| Less portion included in convertible                  |                     |             |
| debt derivatives                                      | (2,983,616)         | (2,250,000) |
| Long term portion of callable secured                 |                     |             |
| convertible promissory notes                          | \$ -                | \$ -        |

| <u>Loans from Stockholders/Related Transactions:</u> | <u>DECEMBER 31,</u> |             |
|--|---------------------|-------------|
|  | <u>2006</u>         | <u>2005</u> |
| Advances from officer/stockholder. Due on demand,    |                     |             |

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with interest accruing at 12% per annum. \$161,525 \$161,525

Long-term debt matures as follows:

| <u>YEAR</u> | CALLABLE<br>SECURED          |                              |                              |                     |
|-------------|------------------------------|------------------------------|------------------------------|---------------------|
|             | <u>UNRELATED<br/>PARTIES</u> | <u>CONVERTIBLE<br/>NOTES</u> | <u>CONVERTIBLE<br/>NOTES</u> | <u>STOCKHOLDERS</u> |
| 2007        | \$ 45,065                    | \$3,304,027                  | \$ -                         | \$ 161,525          |
| 2008        | 34,125                       | -                            | 983,616                      | -                   |
| 2009        | 38,223                       | -                            | 2,000,000                    | -                   |
| 2010        | 42,828                       | -                            | -                            | -                   |
| 2011        | 48,001                       | -                            | -                            | -                   |
| 2012-2023   | 340,954                      | -                            | -                            | -                   |
|             | \$549,196                    | \$3,304,027                  | \$2,983,616                  | \$161,525           |

A financing contract on equipment, with a balance of \$14,589, is in default and is included in current liabilities. The lender has referred the loan to an attorney, but no further action has been taken.

All of the convertible notes and accrued interest, totaling \$3,304,027, are in default. The Company is formulating a plan to seek extensions of these notes. No collection action has been taken by the note holders.

**NOTE 4 Callable Secured Convertible Debt**

In July and August 2005, the Company arranged callable secured convertible debt (Notes) totaling \$2,250,000, bearing interest at 8%, with 3,000,000 five year \$0.15 warrants. The Notes were accompanied by a Registration Rights Agreement. During 2005, the Company received \$1,807,260, net of debt issuance costs of \$217,690, and issued 2,076,923 warrants. In January and February 2006 the Company issued \$1,000,000 in callable secured convertible debt (\$982,500 net of financing costs) and issued 1,423,078 five year warrants exercisable at \$0.15 per share.

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In July and November 2006 the Company arranged additional financings in the amount of \$500,000 each from the same investor group. The Company received \$958,667 (\$1,000,000 net of financing costs) and issued 20,000,000 seven year warrants at an exercise price of \$0.05 per share and 20,000,000 seven year warrants at an exercise price of \$0.04 per share.

The Notes are convertible into common shares at the lesser of \$0.10 or 55% of the market price of the Company's common stock, as defined. Additionally, the Notes are secured by substantially all of the Company's assets. The Notes are further secured by 14,550,558 Company common shares owned by an officer/stockholder.

The Notes are potentially convertible into an unlimited number of common shares. Accordingly, the Company has accounted for the Notes under SFAS 133, EITF 00-19 and DIG's B38 and B39 which require the beneficial conversion features and the prepayment penalties of each of the Notes to be treated as embedded derivatives, to be recorded as a collective liability equal to the estimated fair value of the embedded derivatives. As of December 31, 2006 and 2005 the Notes were convertible into 586,181,548 and 112,593,828 common shares, respectively, and the conversion and prepayment features had estimated fair values of \$4,876,175 and \$3,621,220, respectively. The fair value of the conversion feature and the prepayment penalty were estimated using the Black-Scholes option pricing model and taking a weighted average value based on certain probabilities that the debt would be converted and paid off prior to maturity at specified dates. The estimated fair value of the conversion features and prepayment penalties exceeded the carrying value of the Notes; therefore, the excess was recorded as a loss on derivative instruments in the Consolidated Statements of Operations.

In addition, all non-employee warrants and options that are exercisable during the period that the Notes are outstanding are required to be recorded as liabilities at their fair value. At December 31, 2006 and 2005 non-employee warrants and options to acquire a total of 58,599,501 and 49,542,810 common shares, respectively, were outstanding and had estimated fair values of \$380,083 and \$134,212, respectively.

Assumptions used to value these instruments included assuming the Notes would be converted to common stock in equal amounts on a monthly basis, beginning May 2007, until the estimated full conversion of each Note, assuming all warrants and options would be exercised on their respective expiration dates, using volatility rates ranging from 87% to 109% for December 31, 2006 and 78% to 100% for December 31, 2005, and using risk free interest rates ranging from 4.625% 4.75% for December 31, 2006 and 4.25% to 4.375% for December 31, 2005.

The fair value of the beneficial conversion option, prepayment penalties, warrants and options will be estimated each reporting period with the change in fair value recorded as gain or loss on derivative instruments. As the Company's common stock is highly volatile, material gains or losses for the change in estimated fair value are likely to occur in future periods.

In 2005, the Company entered into a Registration Rights Agreement with the Noteholders that required the Company to use its best efforts to file a registration statement within 120 days of funding. The Agreement required the Company to increase the authorized shares by October 31, 2005 or use its best efforts to do so. The Agreement specifies penalties of 2% per month for failing to register the shares timely and 3% per month for failing to increase the authorized shares. The Company registered 50 million shares in February 2006 and increased the authorized shares in March 2006. Because it used its best efforts, the Company did not incur penalties which would have totaled \$90,000 and \$135,000 through December 31, 2005. The Company entered into similar Registration Rights Agreements in connection with the two 2006 financings. The Company completed a registration of 75 million shares in October 2006 and currently has a registration pending for 75 million shares. The Company believes it is in compliance with the terms of the various Registration Rights Agreements as of December 31, 2006.

During the period of February 15, 2006 to December 31, 2006, the Investors converted a total of \$1,266,384 of the Notes into 111,222,642 common shares. Subsequent to December 31, 2006, the Investors converted a total of \$108,807 into 19,103,320 common shares.

NOTE 5 - Major Customers:

Fertilizer sales for the years ended December 31, 2006 and 2005 include \$1,239,354 and \$997,611, respectively, to one major customer, which represents 95% and 96%, respectively, of fertilizer sales for the years ended December 31, 2006 and 2005. These sales represented 67% and 76% of total GOLD n GRO Fertilizer segment sales for the years ended December 31, 2006 and 2005, respectively. Receivables from this major customer as of December 31, 2006 and 2005 amounted to \$19,442 and \$-0-, which represented 52% of GOLD n GRO fertilizer accounts receivable at December 31, 2006.

Silver sales for 2006 include \$258,089, or 62% of silver sales and 14% of the GOLD n GRO Fertilizer segment sales, to one major customer in the precious metals refining industry. Receivables from this major customer as of December 31, 2006 amounted to \$11,387, which represented 32% of GOLD n GRO fertilizer accounts receivable at December 31, 2006.

Technical services revenues for the years ended December 31, 2006 and 2005 were spread among several customers with relatively small amounts. Revenue from the largest single customer was \$19,082 and \$15,000 for 2006 and 2005, respectively. The Company's major technical services customers operate within the mining industry, both nationally and internationally. Due to the nature of the Company's operations, the major sources of revenues may change from year to year.

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NOTE 6 - Income Taxes:

The following is a reconciliation of the federal statutory tax and tax rate to the Company's provision for taxes and its effective tax rate.

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|   | <u>2006</u>   |               | <u>2005</u>   |               |
|---|---------------|---------------|---------------|---------------|
|   |               | PERCENT       |               | PERCENT       |
|   |               | OF            |               | OF            |
|   |               | PRE-TAX       |               | PRE-TAX       |
|   | <u>AMOUNT</u> | <u>INCOME</u> | <u>AMOUNT</u> | <u>INCOME</u> |
| Federal tax at statutory rate   | \$-           | - %           | \$-           | - %           |
| Temporary differences,<br>primarily bad debt and<br>compensation related expenses | -             | - %           | -             | - %           |
| Non-deductible expenses   | -             | - %           | -             | - %           |
| Utilization of NOL  | -             | - %           | -             | - %           |
| Total Income Tax Expense  | \$-           | 0.0%          | \$-           | 0.0%          |

The Company's consolidated net operating loss available for carry-forward to offset future taxable income and tax liabilities for income tax reporting purposes expire as follows:

| <u>Year Ending December 31:</u> | <u>Net Operating</u><br><u>Loss</u> |
|---------------------------------|-------------------------------------|
| 2007                            | 188,146                             |
| 2008                            | 113,253                             |
| 2012                            | 322,525                             |
| 2018                            | 377,944                             |
| 2019                            | 1,605,954                           |
| 2020                            | 3,254,375                           |

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|      |              |
|------|--------------|
| 2021 | 2,947,351    |
| 2022 | 2,496,744    |
| 2023 | 2,286,436    |
| 2024 | 2,337,832    |
| 2025 | 2,841,914    |
| 2026 | 2,536,124    |
|      | \$21,308,598 |

The Company's total deferred tax assets and related valuation allowances at December 31, 2006 and 2005 are as follows:

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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|                           | <u>2006</u> | <u>2005</u>  |
|---------------------------|-------------|--------------|
| Total deferred tax assets | \$7,650,008 | \$ 6,865,693 |
| Less valuation allowance  | (7,650,008) | (6,865,693)  |
| Net deferred tax asset    | \$ -        | \$ -         |

The estimated deferred tax assets and the related 100% valuation allowance increased \$784,315 between 2005 and 2006.

NOTE 7 - Stock Option and Purchase Plans:

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The following table summarizes warrant and option activity for the period January 1, 2005 through December 31, 2006:

|                                 | <u>Warrants</u> | <u>Convertible<br/>Debt Options</u> | <u>Employee<br/>Options</u> | <u>Total</u>  |
|---------------------------------|-----------------|-------------------------------------|-----------------------------|---------------|
| Under option, December 31, 2004 | 20,596,809      | 25,301,659                          | 5,995,000                   | 51,893,468    |
| Granted                         | 10,943,077      | 118,189,457                         | 165,000                     | 129,297,534   |
| Exercised                       | (1,200,000)     | (8,667,737)                         | -                           | (9,867,737)   |
| Expired                         | (3,026,626)     | -                                   | (52,000)                    | (3,078,626)   |
| Under option, December 31, 2005 | 27,313,260      | 134,823,379                         | 6,108,000                   | 168,244,639   |
| Granted                         | 41,496,924      | 584,810,362                         | 226,000                     | 626,533,286   |
| Exercised                       | (100,000)       | (111,222,642)                       | -                           | (111,322,642) |
| Expired                         | (10,110,683)    | (22,229,551)                        | (12,000)                    | (32,352,234)  |
| Under option, December 31, 2006 | 58,599,501      | 586,181,548                         | 6,322,000                   | 651,103,049   |

The average price for all warrants and options granted and exercised was \$0.0146 for the year ended December 31, 2006 and \$0.0334 for the year ended December 31, 2005.

The following table summarizes warrants and options outstanding as of December 31, 2006:

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ITRONICS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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| No. of | Exercise | Weighted<br>Average<br>Exercise |
|--------|----------|---------------------------------|
|--------|----------|---------------------------------|

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| <u>Expiration Dates</u>    | <u>Shares</u> | <u>Price</u> | <u>Price</u> |
|----------------------------|---------------|--------------|--------------|
| <u>Warrants:</u>           |               |              |              |
| November 2013              | 20,000,000    | \$0.040      |              |
| July 2013                  | 20,000,000    | 0.050        |              |
| March 2007 to May 2009     | 3,000,000     | 0.100        |              |
| January to June 2008       | 5,725,000     | 0.150        |              |
| July 2010 to February 2011 | 3,740,001     | 0.150        |              |
| December 2007              | 1,850,000     | 0.225        |              |
| February 2007              | 360,000       | 0.238        |              |
| January to February 2007   | 1,437,500     | 0.240        |              |
| January to February 2007   | 935,000       | 0.300        |              |
| February to May 2007       | 1,552,000     | 0.375        |              |
| Total Warrants             | 58,599,501    |              | \$ 0.089     |

Weighted  
Average

|                                  | No. of        | Exercise     | Exercise     |
|----------------------------------|---------------|--------------|--------------|
| <u>Convertible Debt Options:</u> | <u>Shares</u> | <u>Price</u> | <u>Price</u> |
| August 2008 to November 2009     | 586,181,548   | \$0.0054     | \$0.0054     |

Employee Options:

|                                |           |          |  |
|--------------------------------|-----------|----------|--|
| August 2007 to February 2016   | 380,000   | \$0.0150 |  |
| One year after employment ends | 1,600,000 | 0.150    |  |
| October 2007                   | 250,000   | 0.200    |  |
| January 2015 to August 2016    | 75,000    | 0.200    |  |



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|                                |             |       |          |
|--------------------------------|-------------|-------|----------|
| One year after employment ends | 1,000,000   | 0.250 |          |
| One year after employment ends | 3,000,000   | 0.300 |          |
| October 2012 to October 2013   | 17,000      | 0.500 |          |
| Total Employee Options         | 6,322,000   |       | \$0.241  |
| Total Warrants and Options     | 651,103,049 |       | \$ 0.015 |

The 586,181,548 convertible debt options listed above are related to the Notes discussed in Note 4. This debt is convertible into common stock at 55% of a calculated market price. Consequently, the number of shares and the conversion price can vary up or down materially, depending on the market price of the Company's stock.

The 22,229,551 in expired convertible debt options listed above is related to the 2000 Series Convertible Promissory Notes discussed in Note 3 above. If the Company is successful in negotiating extensions of these notes, the convertible options may be renewed and the eventual number of potential options could be significantly higher than the amount that expired.

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ITRONICS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 8 Common Stock to be Issued:

The following summarizes stock transactions commencing prior to December 31, with stock issued or to be issued subsequent to that date:

|                                   | <u>2006</u>   |               | <u>2005</u>   |               |
|-----------------------------------|---------------|---------------|---------------|---------------|
|                                   | <u>Amount</u> | <u>Shares</u> | <u>Amount</u> | <u>Shares</u> |
| Payment of salaries (see Note 11) | \$529,725     | 7,620,625     | \$536,188     | 6,646,579     |
| Payment of director fees          | 3,113         | 207,500       | 375           | 7,500         |
| Payment of interest, employees    | 37,430        | 500,703       | 37,430        | 500,703       |
| Payment of debt conversion        | 13,600        | 2,500,000     | -             | -             |

|           |            |           |           |
|-----------|------------|-----------|-----------|
| \$583,868 | 10,828,828 | \$573,993 | 7,154,782 |
|-----------|------------|-----------|-----------|

## NOTE 9 - Accrued Expenses:

The following is the composition of accrued expenses as of December 31:

|                                 | <u>2006</u> | <u>2005</u> |
|---------------------------------|-------------|-------------|
| Accrued vacation                | \$91,615    | \$89,025    |
| Federal and state payroll taxes | 19,699      | 25,030      |
| Sales tax                       | 516         | 5,075       |
| Audit and annual meeting costs  | 95,000      | 120,000     |
|                                 | \$206,830   | \$239,130   |

## NOTE 10 Other Comprehensive Income

The Company held marketable securities that were available for sale, which consisted solely of equity securities. The carrying amount on the balance sheets of these securities is adjusted to fair value at each balance sheet date. The adjustment to fair value is an unrealized holding gain or loss that is reported in Other Comprehensive Income. At present, these unrealized gains or losses are the only component of Accumulated and Other Comprehensive Income. The Company had an Accumulated Unrealized Holding Loss of \$-0- and \$39,889 at December 31, 2006 and 2005, respectively. The Company realized no gross losses and gross gains of \$97,728 on gross proceeds of \$229,374 during the twelve months ended December 31, 2006, and no gains were reclassified out of accumulated other comprehensive income into earnings. The Company realized no gross gains and gross losses of \$10,116 on gross proceeds of \$10,177 during the twelve months ended December 31, 2005, and no gains were reclassified out of accumulated other comprehensive income into earnings. The table below illustrates the amount of unrealized holding gains and losses included in other comprehensive income, net of tax effects of \$0. The reclassification adjustment represents unrealized holding gains and losses transferred into earnings as securities are sold. The Company held no marketable securities as of December 31, 2006.

## ITRONICS INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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Following are the components of Other Comprehensive Income:

Year Ended December 31,

|                                   | <u>2006</u> | <u>2005</u> |
|-----------------------------------|-------------|-------------|
| Unrealized holding gains (losses) |             |             |
| arising during the period         | \$ -        | \$(38,290)  |
| Reclassification adjustment       | 39,889      | 7,969       |
| Other Comprehensive Income        | \$39,889    | \$(30,321)  |

## NOTE 11 - Related Party Transactions:

Promissory notes are held by an officer/stockholder at December 31, 2006 and 2005 (see Note 3 for terms).

\$796,200 and \$594,900 of the accrued management salaries as of December 31, 2006 and 2005, respectively, is for salary in arrears due to several officer/stockholders and employee/stockholders. In addition, salary in arrears of \$514,800 and \$534,800 for 2006 and 2005, respectively, are included in stock to be issued at the respective year ends. These amounts represent the portion of salaries earned but unpaid that the officers/employees/stockholders have agreed to accept in the Company's common stock. The number of shares to be issued is 6,348,958 and 6,620,900 for 2006 and 2005, respectively. Issuance of the stock is pending sufficient cash available to pay the related federal withholding taxes. Interest expense at 12% per annum on salaries due officer and employee/stockholders amounted to \$143,478 and \$123,345, respectively, in 2006 and 2005. Of these amounts, \$-0- and \$58,272 for 2006 and 2005, respectively, were paid (or will be paid) by issuance of -0- and 765,857 shares of restricted common stock.

Interest expense on related party loans amounted to \$19,383 and \$23,948 for the years ended December 31, 2006 and 2005, respectively. Accrued interest on related party loans and accrued salaries totaled \$87,211 and \$13,276 at December 31, 2006 and 2005, respectively.

In March 1999 Dr. Whitney personally agreed to acquire up to 10,000,000 common shares of GPXM at \$0.10 per share, making him beneficial owner of more than ten percent of GPXM at that time. In March 1999, the Company's Board of Directors approved a consulting project for WWI to provide technical services to GPXM; payment was to be made in common stock, and cash. WWI completed the project in early 2005. The Company owned 556,107 shares with a market value of \$91,758 at December 31, 2005. Total revenue from GPXM for 2005 was \$15,000. The Company sold the remaining GPXM shares in 2006 and had no other transactions with GPXM during 2006.

During 2003, WWI's lease of a vehicle utilized by Dr. Whitney was completed. Dr. Whitney purchased the vehicle by financing it through a commercial lender. The purchase price was \$21,741 and the monthly payment for four years is \$531. WWI is leasing the vehicle from Dr. Whitney by making the

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monthly payments to the commercial lender and will acquire ownership of the vehicle when the loan is paid in full.

For related party transactions subsequent to December 31, 2006, see Note 17.

NOTE 12 - Lease Commitments and Rent Expense:

Operating Leases:

The Company leases its corporate office facility under a non-cancelable agreement which expires June 30, 2007. Monthly payments are \$5,222.

A wholly owned subsidiary of the Company, IMI, leases storage facilities on a month-to-month basis and, therefore, no long-term binding contractual obligation exists with regards to minimum lease payments. The monthly rent payment is \$1,050.

Future minimum rental commitments at December 31, 2006, under these operating lease agreements are due as follows:

|      |          |
|------|----------|
| 2007 | \$31,332 |
| 2008 | -        |
|      | \$31,332 |

Total rent expense included in the statements of operations for the years ended December 31, 2006 and 2005 is \$74,370 and \$89,220, respectively.

Capital Leases:

Prior to 2004 the Company had entered into numerous equipment leases, primarily for equipment at the manufacturing facility. The leases were generally for five years, had initial interest rates ranging from 6.7% to 26.3%, with the majority being in the 18% to 21% range, and generally had \$1 buyout options at the end of the lease terms. Substantially all of these leases have been renegotiated or been subject to litigation, as discussed in Note 16, such that the original payments terms are no longer applicable. The renegotiated leases now carry interest rates ranging from 6% to 9.25%.

All of the above described leases are secured by the equipment acquired or financed under the lease.

Future minimum lease commitments at December 31, 2006 are due as follows:

## ITRONICS INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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|                                     | Unrelated      | Related      |
|-------------------------------------|----------------|--------------|
|                                     | <u>Parties</u> | <u>Party</u> |
| 2007                                | \$ 538,386     | \$3,451      |
| 2008                                | 54,000         | -            |
| 2009                                | 54,000         | -            |
| 2010                                | 32,625         | -            |
| 2011                                | 27,000         | -            |
| 2012                                | 9,000          | -            |
|                                     | 715,011        | 3,451        |
| Less: amounts representing interest | (176,446)      | (118)        |
|                                     | \$ 538,565     | \$3,333      |

## NOTE 13 - Business Segments:

The Company and its subsidiaries operate two business segments as identified in Note 1. The following defines business segment

activities:

GOLD n GRO Fertilizer: Photochemical recycling,

Silver recovery, GOLD n GRO

Fertilizer production and

Sales

Mining Technical Services: Mining industry services

The GOLD n GRO fertilizer segment operates principally in Northern Nevada and California. The primary source of revenue for this segment is from the pick-up and processing of photochemicals, recovery of silver therefrom, and sales of GOLD n GRO fertilizer products. The customer base is diverse and includes organizations in the photo-processing, printing, x-ray and medical fields. Fertilizer sales are concentrated in the same geographic markets and the customer base is principally in commercial markets, including specialty agriculture which includes vegetables, fruit and nut trees, and wine and table grapes, golf courses, and turf farms.

The mining technical services segment performs its services primarily out of the Company's Reno, Nevada offices, but its source of clients is not limited to organizations based locally; it has served both national and international clients in the past.

The Company measures segment performance based on net income or loss. At present there are no intercompany revenues. Costs benefiting both segments are incurred by both the Company and by Whitney & Whitney, Inc. Such costs are allocated to each segment based on the estimated benefits to the segment. General and administrative costs incurred by the Company that have no other rational basis for allocation are divided evenly between the segments.  
Cost

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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allocation percentages are reviewed annually and are adjusted based on expected business conditions for the year.

Reconciliation of segment revenues, cost of sales, gross profit (loss), operating income (loss), other income (loss) and net income (loss) to the respective consolidated amounts follows:

|                           | <u>2006</u> | <u>2005</u> |
|---------------------------|-------------|-------------|
| Revenues                  |             |             |
| GOLD n GRO Fertilizer     | \$1,856,074 | \$1,305,144 |
| Mining Technical Services | 28,338      | 55,843      |
| Consolidated Revenues     | \$1,884,412 | \$1,360,987 |
| Cost of Revenues          |             |             |
| GOLD n GRO Fertilizer     | \$1,760,118 | \$1,421,826 |
| Mining Technical Services | 36,607      | 69,167      |

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|   |               |               |
|---|---------------|---------------|
| Consolidated Cost of Revenues               | \$1,796,725   | \$1,490,993   |
| Gross Profit (Loss)                         |               |               |
| GOLD n GRO Fertilizer                       | \$95,956      | \$(116,682)   |
| Mining Technical Services                   | (8,269)       | (13,324)      |
| Consolidated Gross Profit (Loss)            | \$87,687      | \$(130,006)   |
| Operating Income (Loss)                     |               |               |
| GOLD n GRO Fertilizer                       | \$(1,669,970) | \$(2,107,863) |
| Mining Technical Services                   | (542,042)     | (507,831)     |
| Consolidated Operating Income (Loss)        | \$(2,212,012) | \$(2,615,694) |
| Other Income (Expense)                      |               |               |
| GOLD n GRO Fertilizer                       | \$(1,700,833) | \$(2,281,305) |
| Mining Technical Services                   | 102,960       | (9,613)       |
| Consolidated Other Income (Expense)         | \$(1,597,873) | \$(2,290,918) |
| Net Income (Loss)                           |               |               |
| GOLD n GRO Fertilizer                       | \$(3,370,803) | \$(4,389,168) |
| Mining Technical Services                   | (439,082)     | (517,444)     |
| Consolidated Net Income (Loss) before taxes | \$(3,809,885) | \$(4,906,612) |

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ITRONICS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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| Other segment information:                                 | <u>2006</u> | <u>2005</u> |
|--|-------------|-------------|
| Capital expenditures by business segment:                  |             |             |
| GOLD n GRO Fertilizer                                      | \$159,383   | \$185,212   |
| Mining Technical Services                                  | 2,252       | 11,200      |
| Consolidated Capital Expenditures                          | \$161,635   | \$196,412   |
| Depreciation and amortization expense by business segment: |             |             |
| GOLD n GRO Fertilizer                                      |             |             |
| Depreciation   | \$177,754   | \$178,403   |
| Amortization   | 41,370      | 54,884      |
|  | 219,124     | 233,287     |
| Mining Technical Services                                  |             |             |
| Depreciation   | 4,247       | 9,255       |
| Amortization   | 4,646       | 6,583       |
|  | 8,893       | 15,838      |
| Consolidated Depreciation and Amortization                 | \$228,017   | \$249,125   |

General and administrative expenses of \$293,191 and \$190,906 incurred by Itronics Inc. were equally divided between the two segments for 2006 and 2005, respectively.

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ITRONICS INC. AND SUBSIDIARIES

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Identifiable assets by business segment (net of accumulated depreciation, accumulated amortization, and allowance for doubtful accounts):



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| <u>ASSET DESCRIPTION</u>                                  | 2006                                    |  | 2005                                    |  |         |
|---|---|--|---|--|---------|
|   | PHOTO-<br>CHEMICAL<br><u>FERTILIZER</u> | MINING<br>TECHNICAL<br><u>SERVICES</u> | PHOTO-<br>CHEMICAL<br><u>FERTILIZER</u> | MINING<br>TECHNICAL<br><u>SERVICES</u> |         |
|   | Current Assets                          |  |   |  |         |
|   | Cash                                    | \$ -                                   | \$ -                                    | \$ 19,007                              | \$1,382 |
| Accounts receivable, net                                  | 35,102                                  | 1,391                                  | 5,999                                   | 15,165                                 |         |
| Marketable securities                                     | -                                       | -                                      | -                                       | 91,758                                 |         |
| Inventories   | 548,399                                 | -                                      | 590,272                                 | 1,826                                  |         |
| Prepaid expenses  | 55,061                                  | 2,913                                  | 44,042                                  | 1,954                                  |         |
|   | 638,562                                 | 4,304                                  | 659,320                                 | 112,085                                |         |
| Property and Equipment, net                               |   |  |   |  |         |
| Land  | 215,000                                 | -                                      | 215,000                                 | -                                      |         |
| Building and improvements                                 | 961,473                                 | -                                      | 993,914                                 | -                                      |         |
| Construction in progress,<br>manufacturing facility       | 234,347                                 | -                                      | 153,896                                 | -                                      |         |
| Equipment and furniture                                   | 1,232,796                               | 14,455                                 | 1,171,760                               | 18,285                                 |         |
| Vehicles  | 10,391                                  | -                                      | 23,349                                  | -                                      |         |
| Equipment under capital lease-<br>equipment and furniture | 203,044                                 | 65,509                                 | 349,968                                 | 72,877                                 |         |
| Equipment under capital lease-<br>Vehicles                | -                                       | 6,523                                  | -                                       | 10,871                                 |         |
|   | 2,857,051                               | 86,487                                 | 2,907,887                               | 102,033                                |         |

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Other Assets, net

|                                 |             |          |             |           |
|---------------------------------|-------------|----------|-------------|-----------|
| Intangibles                     | 76,500      |          | 76,500      | -         |
| Inter-company investments/loans | -           | -        | -           | 346,252   |
| Deposits                        | 4,427       | 3,483    | 4,427       | 3,483     |
| Deferred loan fees              | 30,646      | -        | 33,901      | -         |
|                                 | 111,573     | 3,483    | 114,828     | 349,735   |
|                                 | \$3,607,186 | \$94,274 | \$3,682,035 | \$563,853 |

Reconciliation of segment assets to consolidated assets:

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ITRONICS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2006 AND 2005

|                                 | <u>2006</u>  | <u>2005</u>  |
|---------------------------------|--------------|--------------|
| Total Assets:                   |              |              |
| GOLD n GRO Fertilizer           | \$3,607,186  | \$3,682,035  |
| Mining Technical Services       | 94,274       | 563,853      |
| Total Segment Assets            | 3,701,460    | 4,245,888    |
| Itronics Inc. assets            | 27,028,313   | 25,175,867   |
| Less: inter-company elimination | (26,464,234) | (25,192,138) |
| Consolidated Assets             | \$4,265,539  | \$4,229,617  |

NOTE 14 - Going Concern:

The Company's consolidated financial statements have been presented on the basis that it is a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. The Company

and its subsidiaries have reported recurring losses from operations, including a net loss of \$3,809,885 during the year ended December 31, 2006, a negative working capital of \$10,139,616, and a stockholders' deficit balance of \$7,429,505 as of December 31, 2006. These factors indicate the Company and its subsidiaries' ability to continue in existence is dependent upon their ability to obtain additional long-term debt and/or equity financing and achieve profitable operations. The consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts and classification of liabilities that might be necessary should the Company and its subsidiaries be unable to continue in existence.

In order to solve the Company's liquidity problems, management has implemented a plan of financing its operations through the private placement of 11,423,078 five year warrants exercisable at \$0.15 per share, conversions of common shares, convertible debt, conversion of debt to common shares, and payment of consulting and other labor services with common shares. The Company obtained financing of \$2 million and \$2.25 million in 2006 and 2005, respectively, through the issuance of callable secured convertible debt. During the first quarter of 2007, the Company obtained \$1 million from the issuance of callable secured convertible debt. For the immediate future, the Company plans to obtain additional debt financing from this investor group.

We are actively working to establish a longer term financing plan that will identify capital sources for the Company's financing needs over a three to five year period. Once this plan is established, needs for financing will be adjusted and the plan will be extended annually.

In addition to continuing the above described efforts, development of the technology necessary to manufacture fertilizer from photochemicals has been completed. In March 1998 the Company's subsidiary, Itronics Metallurgical, Inc., signed a definitive manufacturing and distribution agreement with Western

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ITRONICS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2006 AND 2005

Farm Services, Inc. (WFS). The agreement gives WFS the exclusive license and right to manufacture and market the GOLD n GRO line of fertilizer products in the states of Arizona, California, Hawaii, Idaho, Oregon and Washington. The agreement is for five years, with five year renewal options. In March 2003, the companies entered the second five year term of the agreement.

NOTE 15 - Off-Balance Sheet Risks and Concentration of Credit Risk:

The Company occasionally maintains bank deposits in excess of federally insured limits. The Company's risk is managed by maintaining its accounts in one of the top five largest banks in the country.

As described in Note 5, substantially all the Company's fertilizer sales are concentrated with one major fertilizer distribution customer. In addition, substantially all of those sales are in California, primarily in the Central Valley. Having the majority of such sales concentrated in one region makes the Company's sales more vulnerable to variability caused by weather patterns or economic downturns than if sales were geographically diversified. The Company's plan is to expand geographically to mitigate such effects in the future. At any point in time, a significant portion of the Company's accounts receivable is concentrated with this fertilizer distribution company. This concentration of credit risk is somewhat mitigated due to the fact that the distribution company is one of the largest fertilizer distribution

companies in the country.

Increase or decrease in photochemical recycling service and silver extraction revenues has a direct relationship with federal, state, and local regulations and enforcement of said regulations. Fertilizer revenues are impacted by crop cycles, seasonal variations, and weather patterns.

The ability to recognize a net profit from silver recovery sales is based on the fair market value of silver (London five day average) at the time the photochemicals are obtained versus the fair market value of silver when recovered silver is sold. Most customers are given an 80% silver credit against recycling services based on the content of silver in the photochemicals. If the fair market value of silver declines, our ability to recover our costs could be impacted.

#### NOTE 16 Legal Proceedings and Contingencies

As of December 31, 2006 we have accrued for liabilities, including interest, of \$589,508 which relate to various lawsuits and claims for the collection of the funds due. These include 15 leases totaling \$432,616 (reflected in Capital Lease Obligations) plus \$47,235 in additional interest (reflected in Accrued Interest) and two trade payables totaling \$87,206 (reflected in Accounts Payable) plus \$22,451 in additional interest (reflected in Accrued Interest). The leases are individually secured by specified equipment.

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### ITRONICS INC. AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2006 AND 2005

The accrued interest noted above was recorded based on our assessment of three cases that are seeking \$251,522, which we believe are probable. The creditors have received judgments in these cases, but have taken no further collection action. The Company will continue to accrue interest until these cases are settled or paid in full.

The Company has a total of ten cases, that originally sought \$471,655, that we deem to have a remote possibility of incurring an additional unrecorded

loss. The Company has negotiated payment agreements on these cases and, as of December 31, 2006, the recorded liability for these cases was \$230,835. We are current in our payments under the respective settlement agreements. Subsequent to December 31, 2006, all but two of these cases were paid off.

In addition to the above leases that are subject to litigation, there are four leases, with a recorded liability of \$200,420, that are in default. As required by U.S. Generally Accepted Accounting Principles, the principal balance of the leases that are in default have been classified as current liabilities.

Successful settlement of the above claims is dependent on future financing.

We may become involved in a lawsuit or legal proceeding at any time in the ordinary course of business. Litigation is subject to inherent uncertainties, and an unexpected adverse result may arise that may adversely affect our business. Certain lawsuits have been filed against us for collection of funds due that are delinquent, as described above. Other

than as described above, we are currently not aware of any litigation pending or threatened for any reason other than collection of funds due and already recorded nor are we aware of any additional legal proceeding or claims that the Company believes will have, individually or in the aggregate, a material adverse affect on our business, financial condition or operating results.

NOTE 17 - Subsequent Events:

In January and March 2007 the Company arranged additional callable secured convertible debt financing in the amount of \$500,000 each from the same investor group as discussed in Note 4 above. The notes have a three year term and have interest rates of 6% per annum. The Company received net proceeds of \$990,000 from the two financings and issued a total of 40,000,000 seven year warrants at an exercise price of \$0.01 per share.

The Company issued 32,165,137 shares of its common stock from January 1, 2007 to April 11, 2007 in exchange for the conversion of debt, services received, and asset acquisition totaling \$287,178.

ITEM 14.

PRINCIPAL ACCOUNTANT FEES AND SERVICES

Following is a summary of the aggregate fees billed for professional service by the Company's principal accountant.

|                    | <u>2006</u> | <u>2005</u> |
|--------------------|-------------|-------------|
| Audit fees         | \$134,608   | \$95,009    |
| Audit related fees | -           | -           |
| Tax fees           | -           | -           |
| All other fees     | -           | -           |
| Total              | \$134,608   | \$95,009    |

The Company does not have an audit committee and consequently the entire Board of Directors serves in that capacity. The Board's pre-approval policy regarding professional services provided by the Company's principal accountant is to pre-approve the engagement of the principal accountant for the performance of all professional services. The policy does provide a waiver of pre-approval in the event that such services, in the aggregate, will be less than 5% of the audit fee, such services are not recognized as non-audit fees at the time of the engagement, and pre-approval is obtained from a designated member of the Board prior to the engagement. Until such time as an audit committee is appointed, the designated individual is the Principal Executive Officer, currently the President of the Company.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

ITRONICS INC.

Date: April 16, 2007

By: /S/ JOHN W. WHITNEY

John W. Whitney

President, Treasurer and Director

(Principal Executive Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the Company and in the capacities and on the dates indicated.

Date: April 16, 2007

By: /S/ JOHN W. WHITNEY

John W. Whitney

President, Treasurer and Director

(Principal Executive and Financial  
Officer)

Date: April 16, 2007

By: /S/ MICHAEL C. HORSLEY

Michael C. Horsley

Controller

(Principal Accounting Officer)

Date: April 16, 2007

By: /S/ HOWLAND S. GREEN

Howland S. Green

Director