

PRECISION OPTICS CORPORATION INC  
Form 10QSB  
May 15, 2006

**FORM 10-QSB**

**U.S. SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549**

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

For the quarterly period ended March 31, 2006

Commission file number 001-10647

PRECISION OPTICS CORPORATION, INC.

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

Massachusetts  
(State or other jurisdiction of  
incorporation or organization)

04-2795294  
(I.R.S. Employer  
Identification No.)

22 East Broadway, Gardner, Massachusetts 01440-3338  
(Address of principal executive offices) (Zip Code)

(978) 630-1800

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(Issuer's telephone number, including area code)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 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 "

Indicate by check mark whether the registrant is a shell company (as defined by Rule 12b-2 of the Exchange Act).

Yes "    No x

The number of shares outstanding of issuer's common stock, par value \$.01 per share, at April 30, 2006 was 15,458,212 shares.

Transitional Small Business Disclosure Format (check one):

Yes "    No x

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**PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES**

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Item 1

**PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
**(UNAUDITED)**

	<u><b>ASSETS</b></u>	
	March 31, 2006	June 30, 2005
<b>CURRENT ASSETS</b>		
Cash and Cash Equivalents	\$493,015	\$2,171,693
Accounts Receivable, net	434,144	177,031
Inventories, net	552,090	599,619
Prepaid Expenses	64,849	62,422
<b>Total Current Assets</b>	<b>1,544,098</b>	<b>3,010,765</b>
<b>PROPERTY AND EQUIPMENT</b>		
Machinery and Equipment	3,502,672	3,539,205
Leasehold Improvements	553,596	553,596
Furniture and Fixtures	93,545	96,831
Vehicles	42,343	42,343
Less: Accumulated Depreciation	(4,129,290)	(4,092,202)
<b>Net Property and Equipment</b>	<b>62,866</b>	<b>139,773</b>
<b>OTHER ASSETS</b>		
Cash Surrender Value of Life Insurance Policies	13,483	16,440
Patents, net	210,225	201,627
<b>Total Other Assets</b>	<b>223,708</b>	<b>218,067</b>
<b>TOTAL ASSETS</b>	<b>\$1,830,672</b>	<b>\$3,368,605</b>
 <b><u>LIABILITIES AND STOCKHOLDERS' EQUITY</u></b>		
<b>CURRENT LIABILITIES</b>		
Accounts Payable	360,536	160,593
Customer Advances	-	18,000
Accrued Employee Compensation	176,604	208,851
Accrued Professional Services	53,750	74,000
Other Accrued Liabilities	68,625	57,566
<b>Total Current Liabilities</b>	<b>659,515</b>	<b>519,010</b>
<b>STOCKHOLDERS' EQUITY</b>		
Common Stock, \$.01 par value-		
Authorized — 20,000,000 shares		
Issued and Outstanding - 7,008,212 shares		
at March 31, 2006 and at June 30, 2005	70,082	70,082
Additional Paid-in Capital	32,751,597	32,751,597
Accumulated Deficit	(31,650,522)	(29,972,084)
<b>Total Stockholders' Equity</b>	<b>1,171,157</b>	<b>2,849,595</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$1,830,672</b>	<b>\$3,368,605</b>



**PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**FOR THE THREE AND NINE MONTHS ENDED**  
**MARCH 31, 2006 AND 2005**  
**(UNAUDITED)**

	<b>Three Months Ended March 31,</b>		<b>Nine Months Ended March 31,</b>	
	2006	2005	2006	2005
REVENUES	\$704,010	\$326,272	\$1,652,788	\$987,604
COST OF GOODS SOLD	677,896	369,232	1,686,520	1,298,187
Gross Profit / (Loss)	26,114	(42,960)	(33,732)	(310,583)
RESEARCH and DEVELOPMENT	130,267	330,743	607,537	910,218
SELLING, GENERAL and ADMINISTRATIVE EXPENSES	382,284	459,284	1,222,542	1,393,450
GAIN ON SALE OF ASSETS	-	-	165,700	-
Total Operating Expenses	512,551	790,027	1,664,379	2,303,668
Operating Loss	(486,437)	(832,987)	(1,698,111)	(2,614,251)
INTEREST INCOME	4,262	13,071	19,673	39,998
Net Loss	(\$482,175)	(\$819,916)	(\$1,678,438)	(\$2,574,253)
Basic and Diluted Loss Per Share	(\$0.07)	(\$0.12)	(\$0.24)	(\$0.39)
Weighted Average Common Shares Outstanding - Basic and Diluted	7,008,212	7,008,212	7,008,212	6,662,916

**PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**FOR THE NINE MONTHS ENDED**  
**MARCH 31, 2006 AND 2005(UNAUDITED)**

	<b>Nine Months Ended March 31,</b>	
	2006	2005
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net Loss	\$(1,678,438)	\$(2,574,253)
Adjustments to Reconcile Net Loss to Net Cash		
Used In Operating Activities -		
Depreciation and Amortization	116,991	170,858
Gain on Disposal of Asset	(165,700)	-
Provision for Inventory Write-Down	38,600	187,650
Changes in Operating Assets and Liabilities-		
Accounts Receivable, net	(257,113)	(57,411)
Inventories	8,929	(67,880)
Prepaid Expenses	(2,427)	(21,329)
Accounts Payable	199,943	78,465
Other Accrued Expenses	(41,439)	(3,485)
Net Cash Used In Operating Activities	(1,780,654)	(2,287,385)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of Property and Equipment	(20,667)	(28,813)
Proceeds from Disposal of Asset, net	162,000	-
Increase in Other Assets	(39,357)	(41,702)
Net Cash Provided By (Used In) Investing Activities	101,976	(70,515)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Gross Proceeds from Rights Offering	-	5,256,159
Payment of Deferred Financing Costs	-	(203,598)
Net Cash Provided By Financing Activities	-	5,052,561
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>(1,678,678)</b>	<b>2,694,661</b>
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>	<b>2,171,693</b>	<b>343,260</b>
<b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>	<b>\$493,015</b>	<b>\$3,037,921</b>
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>		
Cash Paid for-		
Income Taxes	\$912	\$912

**PRECISION OPTICS CORPORATION, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation and Operations

The accompanying consolidated financial statements include the accounts of Precision Optics Corporation, Inc. and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

These consolidated financial statements have been prepared by the Company, without audit, and reflect normal recurring adjustments which, in the opinion of management, are necessary for a fair statement of the results of the three and nine months ending March 31, 2006. These consolidated financial statements do not include all disclosures associated with annual consolidated financial statements and, accordingly, should be read in conjunction with footnotes contained in the Company's consolidated financial statements for the year ended June 30, 2005 together with the Report of Independent Registered Public Accounting Firm filed under cover of the Company's 2005 Annual Report on Form 10-KSB.

The Company has incurred significant operating losses during the last nine fiscal years. This trend was primarily the result of the loss of several significant customers, completion of several large nonrecurring government contracts, and operating losses and provision for asset impairment, restructuring, and inventory write-downs associated with the downturn in demand for optical filters used in telecommunications systems. In July 2004, the Company completed a rights offering to stockholders of record at June 7, 2004 by issuing 5,256,159 shares of common stock. Net cash proceeds to the Company (after offering costs of \$222,175) were \$5,033,984. In April 2006 the Company completed a private placement of its common stock raising proceeds of \$2,112,500 (see note 5), less customary transaction expenses, including professional fees associated with the private placement and the subsequent registration of the common stock under the Securities Act of 1933, as amended.

In the past four fiscal years the Company has implemented a number of restructuring and cost saving measures in an effort to align costs with revenues and strengthen financial performance. Most recently, savings were achieved through reduced professional fees, workforce reduction of one full-time employee and changing the chief financial officer role to part-time, and through reduced premiums of the Company's general insurance. In addition, the Company will continue its review of other expense areas to determine where additional reductions in discretionary spending can be achieved.

The Company's current sources of liquidity consist of its cash and cash equivalents and accounts receivable. At March 31, 2006 the Company had \$493,015 in cash and cash equivalents and \$434,144 in accounts receivable.

The Company remains confident in the value of its technology and expertise both in medical and surgical applications and elsewhere. In addition, despite strict controls on R&D spending, the Company continues developing new products and researching technical innovations.

The Company believes that the recent introduction of several new products, along with new and ongoing customer relationships, will generate additional revenues, which are required in order for the Company to achieve profitability. In the coming months the Company will continue to focus its efforts on marketing products recently introduced or redesigned. The Company believes that these marketing activities, if successful, may result in the continuation of its recent pattern of sales growth.

The Company believes, based on its operating and strategic plans and the proceeds received from the private placement in April 2006 (see note 5), that it will have sufficient funds to conduct operations through at least the next 12 months.

#### Use of Estimates

The preparation of these consolidated financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

#### Loss Per Share

Basic loss per share is computed by dividing net loss by the weighted average number of shares of common stock outstanding during the period. For the three and nine months ended March 31, 2006 and 2005, the effect of stock options and warrants was antidilutive; therefore, they were not included in the computation of diluted loss per share. The number of shares issuable upon the exercise of outstanding stock options and warrants that were excluded from the computation as their effect would be antidilutive were approximately 1,336,783 and 181,632 for the three months ended March 31, 2006 and 2005, respectively, and approximately 1,326,783 and 206,804 for the nine months ended March 31, 2006 and 2005.

#### Revenue Recognition

In December 2003, the Securities and Exchange Commission issued Staff Accounting Bulletin ("SAB") No. 104 which establishes guidance in applying generally accepted accounting principles to revenue recognition in financial statements and was effective for the Company's fiscal year 2004. SAB No. 104 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services rendered; (3) the price to the buyer is fixed and determinable; and (4) collectibility is reasonably assured. The Company's shipping terms are customarily FOB shipping point. The Company's revenue recognition practices comply with the guidance in the bulletin.



The sales price of products and services sold is fixed and determinable after receipt and acceptance of a customer's purchase order or properly executed sales contract, typically before any work is performed. Management reviews each customer purchase order or sales contract to determine that the work to be performed is specified and there are no unusual terms and conditions which would raise questions as to whether the sales price is fixed or determinable. The Company assesses credit worthiness of customers based upon prior history with the customer and assessment of financial condition. Accounts receivable are stated at the amount management expects to collect from outstanding balances. An allowance for doubtful accounts is provided for that portion of accounts receivable considered to be uncollectible, based upon historical experience and management's evaluation of outstanding accounts receivable at the end of the year. Bad debts are written off against the allowance when identified.

The Company's revenue transactions typically do not contain multiple deliverable elements for future performance obligations to customers, other than a standard one-year warranty on materials and workmanship, the estimated costs for which are provided for at the time revenue is recognized.

Revenues for industrial and medical products sold in the normal course of business are recognized upon shipment when delivery terms are FOB shipping point and all other revenue recognition criteria have been met. Services that the Company provides to customers consist of repairs and engineering design and development. Recognition of service revenue occurs (assuming all other revenue recognition criteria have been met) upon delivery to the customer of the repaired product. Gross shipping charges reimbursable from customers, to deliver product, are insignificant and are included in Revenues, while shipping costs are shown in Selling, General and Administrative Expenses section of the Consolidated Statement of Operations.

#### Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases.

#### Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123R, *Share-Based Payment* (SFAS 123R), an amendment of FASB Statements No. 123 and No. 95, *Statement of Cash Flows*, which requires companies to measure and recognize compensation expense for all stock-based payments at fair value. Pro forma disclosure will no longer be an alternative. SFAS 123R is effective for the first annual period beginning after December 15, 2005 and thus, will be effective for the Company beginning with the first quarter of fiscal year 2007 (July 1, 2006). Under SFAS 123R, the Company must determine the appropriate fair value model to be used for valuing share-based payments, the amortization for compensation cost and the transition method to be used at the date of adoption. The transition alternatives include retrospective and prospective adoption methods. Under the retrospective method, prior periods may be restated based on the amounts previously recognized under SFAS 123 for purposes of pro forma disclosures either for all periods presented or as of the beginning for the year of adoption.

The prospective method requires that compensation expense be recognized beginning with the effective date, based on the requirements of SFAS 123R, for all share-based payments granted after the effective date, and based on the requirements of SFAS 123, for all awards granted to employees prior to the effective date of SFAS 123R that remain unvested on the effective date.

The Company is evaluating the requirements of SFAS 123R and has not determined its method of adoption or the impact on its financial position or the results of operations. See Note 3 for information related to the pro forma effects on the Company's reported net loss and net loss per share of applying the fair value recognition provisions of the previous SFAS 123 to stock-based employee compensation.

2. INVENTORIES

Inventories are stated at the lower of cost (first-in, first-out) or market and consist of the following:

	March 31, 2006	June 30, 2005
Raw Materials	\$296,164	\$181,548
Work-In-Progress	177,174	185,047
Finished Goods	78,752	233,024
Total Inventories	\$552,090	\$599,619

3. STOCK-BASED COMPENSATION