PRECISION OPTICS CORPORATION INC
Form 10QSB
November 14, 2005

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 September 30, 2005

Commission file number ______ 001-10647________

PRECISION OPTICS CORPORATION, INC.

(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
(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 o

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

Yes o No x

The number of shares outstanding of issuer's common stock, par value $.01 per share, at October 31, 2005 was 7,008,212 shares.

Transitional Small Business Disclosure Format (check one):

Yes o No x

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

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Item 1

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

ASSETS

CURRENT ASSETS		September 30, 2005		June 30, 2005
Cash and Cash Equivalents	$	1,632,318	$	2,171,693
Accounts Receivable, net		210,602		177,031
Inventories, net		597,847		599,619
Prepaid Expenses		95,898		62,422
Total Current Assets		2,536,665		3,010,765
PROPERTY AND EQUIPMENT				
Machinery and Equipment		3,490,022		3,539,205
Leasehold Improvements		553,595		553,596
Furniture and Fixtures		96,831		96,831
Vehicles		42,343		42,343
Less: Accumulated Depreciation		(4,079,887)		(4,092,202)
Net Property and Equipment		102,904		139,773
OTHER ASSETS				
Cash surrender value of life insurance policies		16,440		16,440
Patents, net		206,059		201,627
Total Other Assets		222,499		218,067
TOTAL ASSETS	$	2,862,068	$	3,368,605
LIABILITIES AND STOCKHOLDERS' EQUITY				
CURRENT LIABILITIES				
Accounts Payable	$	235,696		160,593
Customer Advances		-		18,000
Accrued Employee Compensation		171,870		208,851
Accrued Professional Services		100,594		74,000
Other Accrued Liabilities		64,184		57,566
Total Current Liabilities		572,344		519,010
STOCKHOLDERS' EQUITY				
Common Stock, $.01 par value-				
Authorized -- 20,000,000 shares				
Issued and Outstanding - 7,008,212 shares				
at September 30, 2005 and at June 30, 2005		70,082		70,082
Additional Paid-in Capital		32,751,597		32,751,597
Accumulated Deficit		(30,531,955)		(29,972,084)
Total Stockholders' Equity		2,289,724		2,849,595
TOTAL LIABILITIES AND				
STOCKHOLDERS' EQUITY	$	2,862,068	$	3,368,605

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE THREE MONTHS ENDED
SEPTEMBER 30, 2005 AND SEPTEMBER 30, 2004
(UNAUDITED)

	Three Months Ended September 30,			
		2005		2004
REVENUES	$	419,582	$	263,810
COST OF GOODS SOLD		521,501		356,015
Gross Loss		(101,919)		(92,205)
RESEARCH and DEVELOPMENT EXPENSES		208,111		356,406
SELLING, GENERAL and ADMINISTRATIVE EXPENSES		424,688		497,439
GAIN ON SALE OF ASSETS		(165,700)		-
Total Operating Expenses		467,099		853,845
Operating Loss		(569,018)		(946,050)
INTEREST INCOME		9,147		12,592
Net Loss	$	(559,871)	$	(933,458)
Basic and Diluted Loss Per Share	$	(0.08)	$	(0.16)
Weighted Average Common Shares Outstanding - Basic and Diluted		7,008,212		5,979,832

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2005 AND 2004 (UNAUDITED)

	Three Months Ended September 30, 2005		Three Months Ended September 30, 2004	
CASH FLOWS FROM OPERATING ACTIVITIES:				
Net Loss	$	(559,871)	$	(933,458)
Adjustments to Reconcile Net Loss to Net Cash				
Used In Operating Activities -				
Depreciation and Amortization		41,382		49,665
Gain on Disposal of Asset		(165,700)		-
Provision for Inventory Write-Down		-		57,300
Changes in Operating Assets and Liabilities-				
Accounts Receivable,		(33,571)		(25,929)
Inventories		1,772		44,236
Prepaid Expenses		(33,476)		(44,622)
Accounts Payable		75,103		131,269
Other Accrued Expenses		(3,769)		(32,953)
Net Cash Used In Operating Activities		(678,130)		(754,492)
CASH FLOWS FROM INVESTING ACTIVITIES:				
Purchases of Property and Equipment		(8,017)		(1,312)
Proceeds from Disposal of Asset, net		162,000		-
Increase in Other Assets		(15,229)		(5,724)
Net Cash Provided By (Used In) Investing Activities		138,755		(7,036)
CASH FLOWS FROM FINANCING ACTIVITIES:				
Gross Proceeds from Rights Offering		-		5,256,159
Payment of Deferred Financing Costs		-		(104,417)
Net Cash Provided By Financing Activities		-		5,151,742
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS		(539,375)		4,390,214
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD		2,171,693		343,260
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$	1,632,318	$	4,733,474
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:				
Cash Paid for-				
Interest	$	-	$	-
Income Taxes	$	912	$	912

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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 first quarter of the Company's fiscal year 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 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 CFO 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 September 30, 2005 the Company had $1,632,318 in cash and cash equivalents and $210,602 in accounts receivable.

The Company expects its recent pattern of quarter-to-quarter revenue fluctuations to continue, due to the uncertain timing of individual orders and their size in relation to total revenues. 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 on-going customer relationships, will generate additional revenues, which are required in order for the Company to achieve profitability. If these additional revenues are not achieved on a timely basis, the Company will be required and is prepared to implement further cost reduction measures, as necessary. The Company believes, based on its operating and strategic plans, that it will have sufficient funds to conduct operations through at least the next twelve 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 months ended September 30, 2005 and 2004, 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 1,316,783 and 217,914 for the three months ended September 30, 2005 and 2004, respectively.

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.

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. Contract revenues, where the period of performance extends beyond six months, including revenues from customer-sponsored research and development contracts, are recognized under the percentage-of-completion method. The percentage of completion is determined by computing the percentage of the actual cost of work performed to the anticipated total contract costs, or on the basis of units shipped. When the estimate of a contract indicates a loss, the Company's policy is to record the entire estimated loss in the current period. 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:

		September 30, 2005		June 30, 2005
Raw Materials	$	205,828	$	181,548
Work-In-Progress		181,034		185,047
Finished Goods		210,985		233,024
Total Inventories	$	597,847	$	599,619

3. STOCK-BASED COMPENSATION

The Company accounts for its stock-based compensation using the intrinsic value method provided for under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* and related interpretations. Under APB No. 25 and related interpretations, compensation cost is recognized based on the difference, if any, on the date of grant between the fair value of the Company’s stock and the amount an employee must pay to acquire the stock. Statement of Financial Accounting Standards (“SFAS”) No. 123, *Accounting for Stock-Based Compensation*, (as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*), establishes a fair-value-based method of accounting for stock-based compensation plans. The Company has adopted the disclosure-only alternative under SFAS No. 123, which requires the disclosure of the pro forma effects on net loss and net loss per share as if the fair value accounting prescribed by SFAS No. 123 had been adopted.

No stock-based employee compensation cost is reflected in net loss, as all options granted had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net loss and net loss per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation:

	3 Months Ended September 30			
		2005		2004
Net loss, as reported	$	(559,871)	$	(933,458)
Add: Total stock-based employee compensation expense determined under fair value based method for all awards		(107,272)		(9,212)
Pro forma net loss	$	(667,143)	$	(942,670)
Net loss per share:				
As reported - basic and diluted		(.08)		(.16)
Pro forma - basic and diluted	$	(.10)	$	(.16)

The Company has computed the pro forma disclosures required under SFAS No. 123 for fiscal 2005 and 2004 using the Black-Scholes option pricing model prescribed by SFAS No. 123 (See Note 1).

The assumptions used for the three months ended September 30, 2005 are as follows:

		2005
Risk-free interest rates		3.84%
Expected dividend yield		-
Expected lives		5.3 years
Expected volatility		107%
Weighted average fair value of grants	$	0.60

No options were granted in the three months ended September 30, 2004.

On June 13, 2005 the Company issued options to purchase 934,000 shares of common stock at an exercise price of $0.83 per share. At the date of issuance, 30% of the options vested immediately, and the vesting of the remaining options is subject to achievement of certain financial milestones by the Company. According to Accounting Principles Board Opinion No. 25, "*Accounting for Stock Issued to Employees*," the options described above are subject to variable accounting until the awards are exercised, forfeited, or expire unexercised, which includes periodic measurement of compensation expense based on the intrinsic value of the options. The compensation cost will be recognized and adjusted quarterly for vested options or ratably over the vesting period for unvested options. No compensation expense related to these stock options is reflected in the net loss for the quarter ended September 30, 2005 as all options granted had an exercise price greater than the market value of the underlying common stock as of September 30, 2005.