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PRECISION OPTICS CORPORATION INC
Form 10QSB
February 11, 2004

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 December 31, 2003

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 ()

The number of shares outstanding of issuer's common stock, par value \$.01 per share, at January 31, 2004 was 1,752,052 shares.

Transitional Small Business Disclosure Format (check one):

Yes () No (X)

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

INDEX

| | <u>Page</u> |
|---|-------------|
| PART I. FINANCIAL INFORMATION: | |
| Item 1 Consolidated Financial Statements (Unaudited) | |
| Consolidated Balance Sheets December 31, 2003 and June 30, 2003 | 3 |
| Consolidated Statements of Operations Three Months Ended December 31, 2003 and 2002 Six Months Ended December 31, 2003 and 2002 | 4 |
| Consolidated Statements of Cash Flows Six Months Ended December 31, 2003 and 2002 | 5 |
| Notes to Consolidated Financial Statements | 6-8 |
| Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations | 9-16 |
| Item 3 Controls and Procedures | 17 |
| PART II. OTHER INFORMATION | 18-19 |
| Items 1-3 Not Applicable | |
| Item 4 Submission of Matters to a Vote of Security Holders | |
| Item 5 Other Information | |
| Item 6 Exhibits and Reports on Form 8-K (a) Exhibits (b) Reports on Form 8-K | |

Item 1

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

ASSETS

| | December 31, 2003 | June 30, 2003 |
|--|------------------------------|--------------------------|
| | | |
| CURRENT ASSETS | | |
| Cash and Cash Equivalents | \$ 1,726,172 | \$ 3,504,414 |
| Accounts Receivable, Net | 113,190 | 191,669 |
| Inventories | 1,254,138 | 1,257,288 |
| Prepaid Expenses and Other Current Assets | 215,669 | 91,213 |
| Assets Held for Sale | | 152,550 |
| | | |
| Total Current Assets | 3,309,169 | 5,197,134 |
| | | |
| PROPERTY AND EQUIPMENT | 4,197,982 | 4,013,680 |
| Less: Accumulated Depreciation | (3,806,067) | (3,723,350) |
| | | |
| Net Property and Equipment | 391,915 | 290,330 |
| | | |
| OTHER ASSETS | 238,890 | 236,156 |
| | | |
| TOTAL ASSETS | \$ 3,939,974 | \$ 5,723,620 |
| <u>LIABILITIES AND STOCKHOLDERS' EQUITY</u> | | |
| - | | |
| CURRENT LIABILITIES | | |
| Current Portion of Capital Lease Obligation | \$ | \$ 3,826 |
| Accounts Payable | 99,474 | 141,398 |
| Accrued Employee Compensation | 200,491 | 213,543 |
| Accrued Professional Services | 50,994 | 118,284 |
| Accrued Warranty Expense | 50,000 | 50,000 |
| Other Accrued Liabilities | 6,206 | 6,966 |
| | | |
| Total Current Liabilities | 407,165 | 534,017 |
| | | |
| OTHER | | 1,555 |
| | | |
| STOCKHOLDERS' EQUITY | | |
| Common Stock, \$.01 par value- | | |
| Authorized 20,000,000 shares | | |
| Issued and Outstanding 1,752,052 shares | | |
| at December 31, 2003 and June 30, 2003 | 17,521 | 17,521 |
| Additional Paid-in Capital | 27,770,175 | 27,770,175 |
| Accumulated Deficit | (24,254,887) | (22,599,648) |
| | | |
| Total Stockholders' Equity | 3,532,809 | 5,188,048 |
| | | |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 3,939,974 | \$ 5,723,620 |

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PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES
 CONSOLIDATED STATEMENTS OF OPERATIONS
 FOR THE THREE AND SIX MONTHS ENDED
 December 31, 2003 AND 2002
 (UNAUDITED)

| | THREE MONTHS | | SIX MONTHS | |
|---------------------|---------------------|------------|-------------------|--------------|
| | 2003 | 2002 | 2003 | 2002 |
| | <hr/> | <hr/> | <hr/> | <hr/> |
| REVENUES | \$ 226,884 | \$ 589,759 | \$ 865,690 | \$ 1,132,202 |
| COST OF GOODS SOLD | 461,525 | 480,199 | 1,047,788 | 1,011,937 |
| | <hr/> | <hr/> | <hr/> | <hr/> |
| Gross Profit (Loss) | (234,641) | 109,560 | (182,098) | 120,265 |

| | | | | |
|--|----------------|--------------|----------------|----------------|
| RESEARCH and DEVELOPMENT | 334,106 | 339,137 | 601,176 | 649,193 |
| SELLING, GENERAL and ADMINISTRATIVE EXPENSES | 454,328 | 431,091 | 883,658 | 933,320 |
| PROVISION FOR ASSET IMPAIRMENT and RESTRUCTURING | | 53,131 | | 53,131 |
| LOSS ON SALE OF ASSETS HELD FOR SALE | | 14,602 | | 20,041 |
| Total Operating Expenses | 788,434 | 837,961 | 1,484,834 | 1,655,685 |
| Operating Loss | (1,023,075) | (728,401) | (1,666,932) | (1,535,420) |
| INTEREST INCOME | 4,288 | 17,739 | 11,742 | 39,105 |
| INTEREST EXPENSE | (3) | (324) | (49) | (6,562) |
| Net Loss | \$ (1,018,790) | \$ (710,986) | \$ (1,655,239) | \$ (1,502,877) |
| Basic and Diluted Loss Per Share | \$ (0.58) | \$ (0.41) | \$ (0.94) | \$ (0.86) |
| Weighted Average Common Shares Outstanding | 1,752,052 | 1,752,052 | 1,752,052 | 1,752,052 |

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE SIX MONTHS ENDED
DECEMBER 31, 2003 AND 2002
(UNAUDITED)

| | <u>2003</u> | <u>2002</u> |
|--|---------------------|---------------------|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net Loss | \$(1,655,239) | \$(1,502,877) |
| Adjustments to Reconcile Net Loss to Net Cash | | |
| Used In Operating Activities | | |
| Depreciation and Amortization | 103,870 | 130,383 |
| Provision for Asset Impairment and Restructuring | | 53,131 |
| Loss on Sale of Assets Held for Sale | | 20,041 |
| Other | | (6,872) |
| Changes in Operating Assets and Liabilities | | |
| Accounts Receivable, Net | 78,479 | 96,574 |
| Inventories | 3,150 | (156,366) |
| Prepaid Expenses | (124,456) | (140,980) |
| Refundable Income Taxes | | 13,849 |
| Accounts Payable | (41,924) | 40,446 |
| Accrued Restructuring Expense | | (221,102) |
| Customer Advances | | (21,000) |
| Other Accrued Expenses | (82,657) | (39,704) |
| | <u>(1,718,777)</u> | <u>(1,734,477)</u> |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of Property and Equipment | (31,752) | (16,321) |
| Net Proceeds from Sale of Assets Held for Sale | | 550,091 |
| Increase in Other Assets | (23,887) | (11,948) |
| | <u>(55,639)</u> | <u>521,822</u> |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Repayment of Capital Lease Obligation | (3,826) | (23,729) |
| | <u>(3,826)</u> | <u>(23,729)</u> |
| NET DECREASE IN CASH AND CASH EQUIVALENTS | (1,778,242) | (1,236,384) |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD | 3,504,414 | 5,825,601 |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | \$ 1,726,172 | \$ 4,589,217 |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION: | | |
| Cash Paid for- | | |
| Interest | \$ 49 | \$ 6,562 |
| | <u>\$</u> | <u>\$</u> |
| Income Taxes | \$ | \$ 1,824 |
| | <u>\$</u> | <u>\$</u> |

PRECISION OPTICS CORPORATION, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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 second quarter and first half of the Company's fiscal year 2004. 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, 2003 together with the auditors report filed under cover of the Company's 2003 Annual Report on Form 10-KSB.

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 six months ended December 31, 2003 and 2002, 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 220,138 and 202,977, for the three months ended December 31, 2003 and 2002, respectively, and approximately 214,026 and 202,255 for the six months ended December 31, 2003 and 2002 respectively.

2. INVENTORIES

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

| | December 31, 2003 | June 30, 2003 |
|-------------------|-------------------|---------------|
| Raw Materials | \$ 656,677 | \$ 679,647 |
| Work-In-Progress | 391,680 | 379,636 |
| Finished Goods | 205,781 | 198,005 |
| | <hr/> | <hr/> |
| Total Inventories | \$1,254,138 | \$1,257,288 |
| | <hr/> | <hr/> |

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*, 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 December 31, | | 6 Months Ended December 31, | |
|--|--------------------------------|---------------------|--------------------------------|-----------------------|
| | 2003 | 2002 | 2003 | 2002 |
| Net loss, as reported | \$ (1,018,790) | \$ (710,986) | \$ (1,655,239) | \$ (1,502,877) |
| Add: Total stock-based employee compensation expense determined under fair-value-based method for all awards | (17,651) | (25,243) | (42,935) | (45,380) |
| Pro forma net loss | \$ <u>__(1,036,441)</u> | \$ <u>(736,229)</u> | \$ <u>(1,698,174)</u> | \$ <u>(1,548,257)</u> |
| Net loss per share: | | | | |
| As reported basic and diluted | \$ <u>__(0.58)</u> | \$ <u>(.41)</u> | \$ <u>__(0.94)</u> | \$ <u>(.86)</u> |
| Pro forma basic and diluted | \$ <u>__(0.59)</u> | \$ <u>(.42)</u> | \$ <u>__(0.97)</u> | \$ <u>(.88)</u> |

4. ASSETS HELD FOR SALE

In June 2002, certain property and equipment previously invested in the Company's telecommunications product line (whose fair value less cost to sell was estimated at approximately \$848,000 at that time) was reclassified to the category of Assets Held for Sale in the Company's consolidated balance sheet. During fiscal year 2003, the Company received net proceeds of approximately \$553,000 from the sale of a portion of these assets and incurred an impairment charge of approximately \$123,500 based on an updated independent appraisal of fair market value for the remaining assets. As a cost saving measure, during the quarter ended December 31, 2003, the Company redeployed \$21,400 of assets held for sale and invested \$6,300, largely to refurbish certain equipment used to produce optical thin films for its medical instrument product line.

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In accordance with Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, the Company has reclassified the residual unsold portion of these assets (whose fair value less cost to sell is estimated at \$131,150) to Property and Equipment at December 31, 2003 in the accompanying consolidated balance sheet. The Company will resume providing depreciation on these assets beginning in January 2004, using the straight-line method and estimated life of two years, and continue its efforts to sell such assets.

5. LIQUIDITY

The Company's working capital was approximately \$7,418,000, \$4,663,000 and \$4,034,000 at June 30, 2002, June 30, 2003, and September 30, 2003, respectively, and decreased further to approximately \$2,902,000 at December 31, 2003. This trend is primarily the result of losses generated due to the loss of business from a major stereo endoscope customer. The prospects for future sales to this customer remain uncertain. Additionally, sales in the quarter ended December 31, 2003 were adversely affected by customer delays in the introduction of a new system used in cardiac surgical applications, which employs a specialty endoscope developed by the Company.

The Company's current sources of liquidity consist of its cash and cash equivalents and accounts receivable. If these liquidity sources, along with revenues from operations, are not sufficient to fund operations or growth, the Company will require additional financing. The timing and amount of additional financing requirements depend on a number of factors, including the status of development and commercialization efforts, the cost of equipment and personnel to support manufacturing of new and existing products, and the amount of working capital necessary to maintain operations supporting new products. The Company is currently reviewing alternatives for raising additional funds through public or private equity or debt financing. There can be no assurance that such funds will be available on satisfactory terms, if at all. Lack of necessary funds may require the Company to delay, scale back or eliminate some or all of its development efforts.

The Company has taken additional measures to realign its cost structure with current revenue expectations. In January 2004, the Company reduced its workforce by 5 full-time employees, a 15% reduction. As a result of this action, the Company expects to record a non-recurring pretax charge to earnings of approximately \$51,900 for employee severance benefits in the quarter ending March 31, 2004. In addition, the Company is in the process of reviewing other expense areas to determine where additional reductions in discretionary spending can be achieved.

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; however, there can be no assurance that we will generate additional revenues. If these additional revenues are not generated 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 current fiscal year.

Item 2

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

**Management's Discussion and Analysis of Financial
Condition and Results of Operations**

Important Factors Regarding Forward-Looking Statements

When used in this discussion, the words "believes", "anticipates", "intends to", and similar expressions are intended to identify forward-looking statements. Such statements are subject to certain risks and uncertainties which could cause actual results to differ materially from those projected. These risks and uncertainties, many of which are not within the Company's control, include, but are not limited to, uncertainty of future demand for the Company's products; the uncertainty and timing of the successful development of the Company's new products; the risks associated with reliance on a few key customers; the Company's ability to maintain compliance with requirements for continued listing on the Nasdaq SmallCap Market; the Company's ability to attract and retain personnel with the necessary scientific and technical skills; the timing and completion of significant orders; the timing and amount of the Company's research and development expenditures; the timing and level of market acceptance of customers' products for which the Company supplies components; the level of market acceptance of competitors' products; the ability of the Company to control costs associated with performance under fixed price contracts; the performance and reliability of the Company's vendors; and the continued availability to the Company of essential supplies, materials and services. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. The Company undertakes no obligation to publicly release the result of any revision to these forward-looking statements which may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

Overview

Precision Optics Corporation, a developer and manufacturer of advanced optical instruments since 1982, designs and produces high-quality optical thin film coatings, medical instruments, and other advanced optical systems. The Company's medical instrumentation line includes laparoscopes, arthroscopes, endocouplers, and a world-class 3-D endoscope for use in minimally invasive surgical procedures. Precision Optics Corporation is certified to the ISO 9001 Quality Standard, and complies with the FDA Good Manufacturing Practices and the European Union Medical Device Directive for CE Marking of its medical products.

The areas in which the Company does business are highly competitive and include both foreign and domestic competitors. Many of the Company's competitors are larger and have substantially greater resources than the Company. Furthermore, other domestic or foreign companies, some with greater experience in the optics industry and greater financial resources than the Company, may seek to produce products or services that compete with those of the Company. The Company uses production facilities overseas to produce key components for the Company's business, such as lenses. The Company believes that the cost savings from such production is essential to the Company's ability to compete on a price basis in the medical products area particularly and to the Company's profitability generally.

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The Company believes that competition for sales of its medical products and services, which have been principally sold to Original Equipment Manufacturer (OEM) customers, is based on performance and other technical features, as well as other factors, such as scheduling and reliability, in addition to competitive price.

The Company believes that its future success depends to a large degree on its ability to continue to conceive and to develop new optical products and services to enhance the performance characteristics and methods of manufacture of existing products. Accordingly, it expects to continue to seek to obtain product-related design and development contracts with customers and to invest its own funds on research and development, to the extent funds are available.

The Company relies, in part, upon patents, trade secrets and proprietary knowledge as well as personnel policies and employee confidentiality agreements concerning inventions and other creative efforts to develop and to maintain its competitive position. The Company does not believe that its business is dependent upon any particular patent, patent pending, or license, although it believes that trade secrets and confidential know-how may be important to the Company's scientific and commercial success.

The Company conducts its domestic operations at two leased facilities in Gardner, Massachusetts. The Company rents office space in Hong Kong for sales, marketing and supplier quality control and liaison activities of its Hong Kong subsidiary. The Company believes these facilities are adequate for its current operations and adequately covered by insurance. Significant increases in production or the addition of significant equipment or manufacturing capabilities in connection with the production for the Company's line of endoscopes, optical thin films, and other products may, however, require the acquisition or lease of additional facilities.

Critical Accounting Policies and Estimates

General

Management's discussion and analysis of financial condition and results of operations are based upon the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP). The preparation of these 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.

The Company believes the following critical accounting policies affect its more significant judgments and estimates used in the preparation of its consolidated financial statements.

Revenue Recognition

The Company recognizes revenue in accordance with U.S. GAAP and SEC Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements*. SAB No. 101 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 have been rendered; (3) the price to the buyer is fixed and determinable; and (4) collectibility is reasonably assured. Determination of criteria (3) and (4) are based on management's judgments regarding the fixed nature of the price to the buyer charged for products delivered or services rendered and collectibility of the sales price. The Company assesses credit worthiness of customers based upon prior history with the customer and assessment of financial condition. The Company's shipping terms are customarily FOB shipping point.

Bad Debt

The Company maintains allowances for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. Allowances for doubtful accounts are established based upon review of specific account balances and historical experience. If the financial condition of the Company's customers were to deteriorate, resulting in an impairment of their ability to make future payments, additional allowances may be required.

Inventories

The Company provides for estimated obsolescence on unmarketable inventory based upon assumptions about future demand and market conditions. If actual demand and market conditions are less favorable than those projected by management, additional inventory write downs may be required. Inventory, once written down, is not subsequently written back up, as these adjustments are considered permanent adjustments to the carrying value of the inventory.

Impairment of Long-Lived Assets and Long-Lived Assets to be Disposed of

In accordance with Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, the Company assesses impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to undiscounted future net cash flows expected to be generated by the asset. Estimating the future cash flows expected to be generated by the asset is dependent upon significant judgments made by management. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. The Company classifies assets to be sold as held for sale in the period in which all of the following criteria are met:

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- a) Management, having the authority to approve the action, commits to a plan to sell the asset.
- b) The asset is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets.
- c) An active program to locate a buyer and other actions required to complete the plan to sell the asset have been initiated.
- d) The sale of the asset is probable, and transfer of the asset is expected to qualify for recognition as a completed sale, generally within one year.
- e) The asset is being actively marketed for sale at a price that is reasonable in relation to its current fair value.
- f) Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

Assets classified as held for sale are carried at the lower of cost or fair value less cost to sell and the asset is no longer depreciated. When determining the fair value, management considers the condition of the assets and pertinent market conditions. When considered necessary, management will engage third party valuation experts to assist in the determination of fair value. At each balance sheet date, management makes an assessment of the assets' fair value and whether the assets continue to meet the criteria to be classified as held for sale.

Results of Operations

Total revenues for the quarter and six months ended December 31, 2003 decreased by \$362,875, or 61.5%, and \$266,512, or 23.5%, respectively, from the same periods in the prior year. Revenues for the quarter decreased 64.4% sequentially from the preceding quarter.

The decrease in revenues for the quarter was due primarily to lower sales of medical products (down by approximately \$357,000, or 64%). Sales of medical products were lower due primarily to lower shipments of stereo endoscope products.

The revenue decrease from the prior year for the six months ended December 31, 2003 was due to lower sales of medical products (down by approximately \$257,000, or 24%). Medical sales were lower due primarily to lower shipments of stereo endoscope products, partially offset by shipments to a new customer (in the quarter ended September 30, 2003) of specialty endoscopes used for cardiac surgical applications.

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Revenues from the Company's largest customers, as a percentage of total revenues for the six months ended December 31, 2003 and 2002, were as follows:

| | 2003 | 2002 |
|------------|-------------|-------------|
| Customer A | 36 | 1 |
| Customer B | 15 | 15 |
| Customer C | 3 | 10 |
| Customer D | | 36 |
| All Others | 46 | 38 |
| | <u>100%</u> | <u>100%</u> |

No other customer accounted for more than 10% of the Company's revenues during those periods.

At December 31, 2003, receivables from the Company's three largest customers were approximately 35%, 13% and 13%, respectively, of the total accounts receivable. At June 30, 2003, receivables from the Company's largest customer were approximately 55% of the total accounts receivable. No other customer accounted for more than 10% of the Company's receivables as of December 31, 2003 and June 30, 2003.

Gross profit (loss) for the quarter and six months ended December 31, 2003 reflected an unfavorable change of approximately \$344,000 and \$302,000, respectively, compared to the quarter and six months ended December 31, 2002. Gross profit as a percentage of revenues decreased from 18.6% in the quarter ended December 31, 2002 to a negative 103.4% in the quarter ended December 31, 2003, and decreased from 10.6% in the six months ended December 31, 2002 to a negative 21.0% in the six months ended December 31, 2003. The unfavorable change in gross profit was due primarily to lower overall sales volume, partially offset by a lower manufacturing cost structure resulting from restructuring measures implemented in fiscal year 2003.

Research and development expenses decreased by approximately \$5,000, or 1%, for the quarter ended December 31, 2003, and by approximately \$48,000, or 7.4%, for the six months ended December 31, 2003 compared to the corresponding periods of the prior year. The decrease was due to a slightly lower level of resources being devoted to product development activities.

Selling, general and administrative expenses increased by approximately \$23,000, or 5.4%, for the quarter ended December 31, 2003, but decreased by approximately \$50,000, or 5.3%, for the six months ended December 31, 2003 compared to the corresponding periods of the prior year. The increase for the quarter is due primarily to higher sales proposal expenses. The year to date decrease is due primarily to lower outside consulting and legal expenses.

The provision for asset impairment and restructuring of \$53,131 in the quarter and six months ended December 31, 2002, consists of a provision for severance benefits paid in the quarter ended December 31, 2002 related to the October 2002 workforce reduction of 16%, or six employees.

Interest expense relates primarily to capital lease obligations.

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Interest income decreased by approximately \$13,000 for the quarter and by \$27,000 for the six months ended December 31, 2003 compared to the corresponding periods of the prior year due to the lower base of cash and cash equivalents and to lower interest rates.

The loss on sale of assets held for sale of \$14,602 and \$20,041 in the quarter and six months ended December 31, 2002, respectively, represents the loss on the sales of a portion of the property and equipment held for sale, which formerly was invested in the Company's telecommunications product line. The Company received net proceeds from these sales of approximately \$550,000 in the six months ended December 31, 2002.

No income tax provision was recorded in the first or second quarters of fiscal year 2004 or 2003 because of the losses generated in those periods.

Liquidity and Capital Resources

For the six months ended December 31, 2003, the Company's cash and cash equivalents decreased by approximately \$1,778,000 to \$1,726,000. The decrease in cash and cash equivalents was due to cash used by operating activities of approximately \$1,719,000, capital expenditures of approximately \$31,000, repayment of debt of approximately \$4,000, and an increase in patent costs of approximately \$24,000. Cash used by operating activities consisted of the net loss of approximately \$1,655,000 and an increase in prepaid expenses of approximately \$124,000, partially offset by other net changes in balance sheet items totaling approximately \$60,000.

The Company's working capital was approximately \$7,418,000, \$4,663,000 and \$4,034,000 at June 30, 2002, June 30, 2003, and September 30, 2003, respectively, and decreased further to approximately \$2,902,000 at December 31, 2003. This trend is primarily the result of losses generated due to the loss of business from a major stereo endoscope customer. The prospects for future sales to this customer remains uncertain. Additionally, sales in the quarter ended December 31, 2003 were adversely affected by customer delays in the introduction of a new system used in cardiac surgical applications which employs a specialty endoscope developed by the Company. Despite these delays, the Company anticipates follow-on orders from this customer.

Contractual cash commitments for the fiscal years subsequent to December 31, 2003 are summarized as follows:

| | 2004 | 2005 | Thereafter | Total |
|------------------|-----------|----------|------------|-----------|
| Operating leases | \$ 25,955 | \$ 3,383 | \$ | \$ 29,338 |
| Total | \$ 25,955 | \$ 3,383 | \$ | \$ 29,338 |

During the quarter ended December 31, 2003, the Company paid the final installment on its capital lease obligation. For the six months ended December 31, 2003, payments on capital lease obligations totaled approximately \$3,900. For the year ended June 30, 2003 and 2002, payments on capital lease obligations totaled approximately \$33,000 and \$44,000, respectively.

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As a cost saving measure, during the quarter ended December 31, 2003, the Company redeployed \$21,400 of assets held for sale and invested an additional \$6,300, largely to refurbish certain equipment used to produce optical thin films for its medical instrument product line. This refurbishment is expected to result in reduced operating supplies totaling approximately \$35,000 per year.

The Company provides a standard one-year warranty on materials and workmanship to its customers. The Company provides for estimated warranty costs at the time product revenue is recognized. Warranty costs are included as a component of cost of goods sold in the accompanying consolidated statements of operations. For the six month periods ended December 31, 2003 and 2002, warranty costs were not significant.

The Company intends to continue devoting resources to internally funded research and development spending on both new products and the improvement of existing products. The Company also intends to devote resources to the marketing and product support of its medical instrument product line and medical instruments related optical thin films. These investments may temporarily result in negative cash flow, but the Company anticipates that the result of these efforts will translate into increased revenues.

The Company's current sources of liquidity consist of its cash and cash equivalents and accounts receivable. If these liquidity sources, along with revenues from operations, are not sufficient to fund operations or growth, the Company will require additional financing. The timing and amount of additional financing requirements depend on a number of factors, including the status of development and commercialization efforts, the cost of equipment and personnel to support manufacturing of new and existing products, and the amount of working capital necessary to maintain operations supporting new products. The Company is currently reviewing alternatives for raising additional funds through public or private equity or debt financing. There can be no assurance that such funds will be available on satisfactory terms, if at all. Lack of necessary funds may require the Company to delay, scale back or eliminate some or all of its development efforts.

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; however, there can be no assurance that we will generate additional revenues. If these additional revenues are not generated 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 current fiscal year.

Recent Accounting Pronouncements

In January 2003, the Financial Accounting Standards Board (FASB) issued Interpretation No. 46, *Consolidation of Variable Interest Entities, an interpretation of ARB No. 51*. This interpretation addresses the consolidation by business enterprises of variable interest entities as defined in the Interpretation. The Interpretation applies immediately to variable interests in variable interest entities created after January 31, 2003, and to variable interests in variable interest entities obtained after January 31, 2003. For public enterprises with a variable interest in a variable interest entity created before February 1, 2003, the Interpretation applies to that enterprise no later than the beginning of the first interim or annual reporting period beginning after June 15, 2003. The application of this Interpretation did not have a material impact on the Company's consolidated results of operations or financial position.

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In November, 2002, the Emerging Issues Task Force (EITF) reached a consensus on Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*. EITF Issue No. 00-21 addresses the accounting, by a vendor, for contractual arrangements in which multiple revenue-generating activities will be performed by the vendor. The Issue addresses when and, if so, how an arrangement involving multiple deliverables should be divided into separate units of accounting. The Issue also addresses how the arrangement consideration should be measured and allocated to the separate units of accounting in the arrangement. This Issue otherwise does not change applicable revenue recognition criteria. The Company adopted the provisions of EITF No. 00-21 to new arrangements initiated after July 1, 2003, without a material impact on the Company's consolidated results of operations or financial position.

Trends and Uncertainties That May Affect Future Results

For the quarter ended December 31, 2003, cash and cash equivalents decreased by approximately \$1,024,000 compared to a decrease of approximately \$754,000 for the previous quarter ended September 30, 2003. Cash disbursements during the quarter ended December 31, 2003, included approximately \$330,000 for certain payments occurring only during the second quarter each year, such as annual insurance premiums and costs associated with preparation of annual reports and shareholder proxy materials.

Capital equipment expenditures during the six months ended December 31, 2003 were approximately \$32,000, up 95% from the same period in 2002. Future capital expenditures will depend on future sales and the success of ongoing research and development efforts.

For the quarter ended December 31, 2003, research and development expenses were approximately \$334,000, down 1% from \$339,000 for the quarter ended December 31, 2002. Quarterly research and development expenses are expected to remain at this level for the foreseeable future, but will ultimately depend on the Company's assessment of new product opportunities.

The Company expects its recent pattern of quarter-to-quarter revenue fluctuations to continue, due to the uncertain timing of orders from customers and their size in relation to total revenues. The Company continues to move forward with new products and technical innovations, in particular, the development of a new generation (patent pending) of its world-class product line of 3-D endoscopes, the development of a new prototype 2.7 mm endoscope, and new instruments utilizing the Company's new micro-precision™ lens technology (patent pending) for endoscopes under 1 mm.

Item 3

Controls and Procedures

The Company's Chief Executive Officer and Chief Financial Officer have conducted an evaluation of the Company's disclosure controls and procedures as of December 31, 2003. Based on their evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the applicable Securities and Exchange Commission rules and forms. There were no significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the date of the most recent evaluation of these controls by the Company's Chief Executive Officer and Chief Financial Officer, including any corrective actions with regard to significant deficiencies and material weaknesses.

PART II. OTHER INFORMATION

Items 1-3 Not Applicable.

Item 4 Submission of Matters to a Vote of Security Holders

At the Annual Meeting of Shareholders of the Company held on November 11, 2003, 1,507,589 (or 86%) of the 1,752,052 then-outstanding shares of the common stock of the Company were present and voted by proxy. Richard E. Forkey was reelected as a Class I Director of the Company, by a vote of 1,445,650 shares for, 0 shares against and 61,939 shares withheld. Edward A. Benjamin was reelected as a Class I Director of the Company, by a vote of 1,448,160 shares for, 0 shares against and 59,429 shares withheld. The shareholders also approved a proposal to approve an amended and restated 1997 Incentive Plan of the Company by a vote of 422,091 shares for, 89,646 shares against, and 3,791 shares abstaining.

Item 5 Other Information

As previously announced, Dr. Joseph N. Forkey was appointed Chief Scientist of the Company in September 2003. Dr. Forkey's appointment is expected to provide the company significant additional capabilities in optical instrument development, in management of new technology and in potentially significant longer-term initiatives in Biophysics and Biomedical instrumentation, as well as new photonics-based market opportunities.

An article co-authored by Dr. Forkey was included in the list of the 10 most important scientific breakthroughs of the year 2003 by the journal *Science* (Vol. 302, p. 2039). The work was authored by a collaboration of scientists including Dr. Forkey while he was a Research Scientist at the University of Pennsylvania Medical School. The Research Article entitled "Myosin V Walks Hand-over-Hand: Single Fluorophore Imaging with 1.5 nanometer Localization" was originally published in *Science* in June 2003 (Vol. 300, p.2061) and described the development of a new optical microscope for measuring the location of individual fluorescent molecules with unprecedented accuracy. The paper also described the use of this technique to observe the motion of specific parts of individual protein molecules revealing previously unobserved structural changes in the protein. *Science* is the weekly publication of the American Association for the Advancement of Science.

Dr. Forkey, in his capacity as Chief Scientist, expects to continue to explore the development and application of optical-based microscopic single-molecule technologies.

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Item 6 Exhibits and Reports on Form 8-K

(a) Exhibits

Exhibit 31.1 Certification of the Company's Chief Executive Officer required by Rule 13a-14(a)/15d-14(a).

Exhibit 31.2 Certification of the Company's Chief Financial Officer required by Rule 13a-14(a)/15d-14(a).

Exhibit 32.1 Certifications of the Company's Chief Executive Officer and Chief Financial Officer required by Rule 13a-14(b) and 18 U.S.C. 1350.

(b) Reports on Form 8-K The Company filed one Current Report on Form 8-K during the quarter ended December 31, 2003 as follows: On November 13, 2003, the Company reported a press release issued on November 10, 2003, reporting its operating results for the quarter ended September 30, 2003.

In accordance with the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

PRECISION OPTICS CORPORATION, INC.

Date: February 11, 2004

By: /s/ JACK P. DREIMILLER

Jack P. Dreimiller
Senior Vice President, Finance, Chief Financial Officer and Clerk