PRECISION OPTICS CORPORATION INC
Form 10QSB
May 10, 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 March 31, 2005

Commission file number 001-10647

PRECISION OPTICS CORPORATION, INC.

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

Massachusetts	04-2795294
(State or other jurisdiction of incorporation or organization)	(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

The number of shares outstanding of issuer's common stock, par value $.01 per share, at April 30, 2005 was 7,008,212 shares.

Transitional Small Business Disclosure Format (check one):
Yes o No x

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES
INDEX

		Page
PART I.	FINANCIAL INFORMATION:	
Item 1	Consolidated Financial Statements (Unaudited)	
	Consolidated Balance Sheets - March 31, 2005 and June 30, 2004	3
	Consolidated Statements of Operations - Three Months Ended March 31, 2005 and 2004 Nine Months Ended March 31, 2005 and 2004	4
	Consolidated Statements of Cash Flows -Nine Months Ended March 31, 2005 and 2004	5
	Notes to Consolidated Financial Statements	6-8
Item 2	Management's Discussion and Analysis of Financial Condition and Results of Operations	9-15
Item 3	Controls and Procedures	16
PART II.	OTHER INFORMATION	17
Items 1-5	Not Applicable	
Item 6	Exhibits	

Item 1

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

ASSETS		
CURRENT ASSETS	March 31, 2005	June 30, 2004
Cash and Cash Equivalents	$ 3,037,921	$ 343,260
Accounts Receivable, Net	137,606	80,195
Inventories, Net	798,228	917,998
Prepaid Expenses and Other Current Assets	101,975	80,646
Deferred Financing Costs	-	171,885
Total Current Assets	4,075,730	1,593,984
PROPERTY AND EQUIPMENT	4,228,648	4,199,835
Less: Accumulated Depreciation	(4,048,133)	(3,920,593)
Net Property and Equipment	180,515	279,242
OTHER ASSETS	222,472	224,088
TOTAL ASSETS	$ 4,478,717	$ 2,097,314
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts Payable	$ 160,208	235,050
Accrued Employee Compensation	207,608	230,110
Accrued Professional Services	67,073	75,439
Accrued Warranty Expense	50,000	50,000
Other Accrued Liabilities	30,126	2,743
Total Current Liabilities	515,015	593,342
STOCKHOLDERS' EQUITY		
Common Stock, $.01 par value- Authorized -- 20,000,000 shares		
Issued and Outstanding – 7,008,212 shares at March 31, 2005 and 1,752,053 shares at June 30, 2004	70,082	17,521
Additional Paid-in Capital	32,751,597	27,770,175
Accumulated Deficit	(28,857,977)	(26,283,724)
Total Stockholders' Equity	3,963,702	1,503,972
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 4,478,717	$ 2,097,314

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE THREE AND NINE MONTHS ENDED
MARCH 31, 2005 AND 2004
(UNAUDITED)

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2005	2004	2005	2004
REVENUES	$ 326,272	$ 313,698	$ 987,604	$ 1,179,388
COST OF GOODS SOLD	369,232	467,178	1,298,187	1,514,966
Gross Profit (Loss)	(42,960)	(153,480)	(310,583)	(335,578)
RESEARCH and DEVELOPMENT	330,743	379,518	910,218	980,694
SELLING, GENERAL and ADMINISTRATIVE EXPENSES	459,284	436,666	1,393,450	1,320,324
PROVISION FOR RESTRUCTURING	-	52,208	-	52,208
Total Operating Expenses	790,027	868,392	2,303,668	2,353,226
Operating Loss	(832,987)	(1,021,872)	(2,614,251)	(2,688,804)
INTEREST INCOME	13,071	4,560	39,998	16,302
INTEREST EXPENSE	-	-	-	(49)
Net Loss	$ (819,916)	$ _(1,017,312)	$ (2,574,253)	$ (2,672,551)
Basic and Diluted Loss Per Share	$ (0.12)	$ (0.58)	$ (0.39)	$ (1.53)
Weighted Average Common Shares Outstanding	7,008,212	1,752,053	6,662,916	1,752,053

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE NINE MONTHS ENDED
MARCH 31, 2005 AND 2004
(UNAUDITED)

	Nine Months Ended March 31,	
	2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net Loss	$ (2,574,253)	$ (2,672,551)
Adjustments to Reconcile Net Loss to Net Cash Used In Operating Activities -		
Depreciation and Amortization	170,858	169,499
Provision for Inventory Write-Down	187,650	308,800
Changes in Operating Assets and Liabilities-		
Accounts Receivable, Net	(57,411)	62,846
Inventories	(67,880)	(207,692)
Prepaid Expenses	(21,329)	(66,239)
Accounts Payable	78,465	(31,105)
Customer Advances	-	2,575
Other Accrued Expenses	(3,485)	(48,001)
Net Cash Used In Operating Activities	(2,287,385)	(2,481,868)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of Property and Equipment	(28,813)	(31,804)
Increase in Other Assets	(41,702)	(41,266)
Net Cash Used In Investing Activities	(70,515)	(73,070)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayment of Capital Lease Obligation	-	(3,826)
Gross Proceeds from Rights Offering	5,256,159	-
Payment of Deferred Financing Costs	(203,598)	-
Net Cash Provided By (Used In) In Financing Activities	5,052,561	(3,826)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	2,694,661	(2,558,764)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	343,260	3,504,414
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 3,037,921	$ 945,650

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

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 third quarter and nine months of the Company's fiscal year 2005. 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, 2004 together with the auditors' report filed under cover of the Company's 2004 Annual Report on Form 10-KSB.

Certain reclassifications have been made to the prior period consolidated financial statements to conform to current period presentation with no effect to the Company’s reported net loss or financial position.

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.

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 month periods ended March 31, 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 181,632 and 220,422 for the three months ended March 31, 2005 and 2004, respectively, and approximately 206,804 and 216,158 for the nine months ended March 31, 2005 and 2004, respectively.

2. INVENTORIES

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

	March 31, 2005		June 30, 2004	
Raw Materials	$	193,384	$	345,483
Work-In-Progress		346,933		307,522
Finished Goods		257,911		264,993
Total Inventories	$	798,228	$	917,998

The Company recorded, in cost of goods sold, provisions for slow-moving and obsolete inventories of $38,650 and $124,700 for the three months ended March 31, 2005 and 2004, respectively, and $187,650 and $308,800 for the nine months ended March 31, 2005 and 2004, respectively.

3. STOCK-BASED COMPENSATION

The Company accounts for its stock-based compensation using the intrinsic value method provided for under Accounting Principles Board Opinion (“APB”) 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:

	Three Months Ended March 31,				**Nine Months Ended March 31,**			
	2005		**2004**		**2005**		**2004**	
Net loss, as reported	$	(819,916)	$	(1,017,312)	$	(2,574,253)	$	(2,672,551)
Add: Total stock-based employee compensation expense determined under fair-value-based method for all awards		(7,100)		(9,448)		(38,412)		(52,383)
Pro forma net loss	$	(827,016)	$	(1,026,760)	$	(2,612,665)	$	(2,724,934)
Net loss per share: As reported - basic and diluted	$	(0.12)	$	(0.58)	$	(0.39)	$	(1.53)
Pro forma - basic and diluted	$	(0.12)	$	(0.59)	$	(0.39)	$	(1.56)

4. RIGHTS OFFERING

In July 2004, the Company completed a rights offering to stockholders of record on June 7, 2004 by issuing 5,256,159 shares of common stock at a price of $1.00 per share. Net cash proceeds to the Company (after offering costs of $222,176) were $5,033,983.

The costs of the rights offering estimated to have been incurred through June 30, 2004 of $171,885, have been deferred and are included in deferred financing costs in the accompanying consolidated balance sheets as of June 30, 2004. The actual offering costs of $222,176 have been charged against additional paid-in capital in the accompanying consolidated balance sheets as of December 31, 2004.

5. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123R, *Share-Based Payment: an amendment of FASB Statements* No. 123 *and* 95 (SFAS 123R), which requires companies to measure and recognize compensation expense for all stock-based payments at fair value. SFAS 123R is effective for all annual periods 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). Early adoption is encouraged and retroactive application of the provisions of SFAS 123R to the beginning of the fiscal year that includes the effective date is permitted, but not required. The Company is currently evaluating the impact of SFAS 123R on its financial position and 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.

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; which are described further in Exhibit 99.1 to the Company’s Annual Report on Form 10-KSB for the fiscal year ended June 30, 2004. 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 and endocouplers and a world-class product line of 3-D endoscopes for use in minimally invasive surgical procedures.

The Company is currently developing specialty instruments incorporating its patent-pending LENSLOCKTM technology, which we believe may result in lower cost, easier repairability and enhanced durability, as well as ultra-small instruments (some with lenses less than one millimeter in diameter) utilizing patent-pending micro-precisionTM lens technology. The Company is also exploring new initiatives in single-molecule technology and nanotechnology for biomedical and other applications.

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 Company’s Internet Website is www.poci.com.

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.

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. 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. 104, *Revenue Recognition.* 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 have been rendered; (3) the price to the buyer is fixed and determinable; and (4) collectibility is reasonably assured.

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. The Company's shipping terms are customarily FOB shipping point. The Company's revenue transactions typically contain neither multiple deliverable elements or 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, which amounted to approximately 8% of total Company revenues in each of the quarter and nine months ended March 31, 2005, 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, or in the case of engineering design and development services, when the design or a prototype instrument has been delivered to the customer. 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.

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.

Results of Operations

Total revenues for the quarter ended March 31, 2005 increased by $12,574, or 4.0%, from the same period in the prior year. Revenues for the quarter decreased 17.9% sequentially from the preceding quarter. Total revenues for the nine months ended March 31, 2005 decreased by $191,784, or 16.3% from the same period in the prior year.

The increase in revenues for the quarter was due primarily to higher sales of medical products (up by $8,210, or 3.8%) and higher sales of non-medical products (up by $4,364, or 4.6%). Sales of medical products were higher due primarily to higher shipments of beamsplitters, micro optic lenses and micro couplers. Sales of non-medical products were higher due primarily to higher shipments of industrial lenses, couplers and thin film coatings.

The revenue decrease from the prior year for the nine months ended March 31, 2005 was due to lower sales of medical products (down by $258,624, or 25.5%) partially offset by higher sales of non-medical products (up by $66,840 or 40.7%). Sales of medical products were lower due primarily to one-time shipments last year to a customer of specialty endoscopes used for cardiac surgical applications. Non-medical product sales were higher due primarily to higher sales of industrial lenses, couplers and thin film coatings.

Revenues from the Company's largest customers, as a percentage of total revenues for the nine months ended March 31, 2005 and 2004, were as follows:

	2005	**2004**
Customer A	22	20
Customer B	11	5
Customer C	-	27
All Others	67	48
	100%	100%

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

At March 31, 2005, receivables from the Company's three largest customers were approximately 17%, 14% and 12%, respectively, of the total accounts receivable. At June 30, 2004, receivables from the Company's four largest customers were approximately 47%, 18%, 13%, and 12%, respectively, of the total accounts receivable. No other customer accounted for more than 10% of the Company's receivables as of March 31, 2005 and June 30, 2004.

Gross profit (loss) for the quarter ended March 31, 2005 reflected a favorable change of $110,520 compared to the quarter ended March 31, 2004. Gross profit (loss) as a percentage of revenues improved from a negative 48.9% in the quarter ended March 31, 2005 to a negative 13.2% in the quarter ended March 31, 2005. The favorable change in gross profit was due primarily to a lower manufacturing cost structure resulting from restructuring measures implemented in fiscal year 2004, and by lower provisions for slow-moving and obsolete inventories recorded in the quarter ended March 31, 2005 of $38,650 compared to $124,700, recorded in the quarter ended March 31, 2004.

Gross profit (loss) for the nine months ended March 31, 2005 reflected a favorable change of $24,995 compared to the nine months ended March 31, 2004. Gross profit as a percentage of revenues changed from a negative 28.5% last year to a negative 31.4% this year. The change in gross profit was due to the lower provisions for slow-moving and obsolete inventories recorded in the nine month period ended March 31, 2005 ($187,650 this year compared to $308,800 last year) and by a lower manufacturing cost structure referred to above, partially offset by lower sales volume this year.

Research and development expenses decreased by $48,775, or 12.9%, for the quarter ended March 31, 2005, and by $70,476, or 7.2%, for the nine months ended March 31, 2005 compared to the corresponding periods of the prior year. The decrease reflects a shift in certain resources to customer-sponsored development efforts (the costs of which are included in cost of goods sold), resulting in initial shipments of new products to several customers.

Selling, general and administrative expenses increased by $22,618, or 5.2%, for the quarter ended March 31, 2005, and increased by $73,126, or 5.5%, for the nine months ended March 31, 2005 compared to the corresponding periods of the prior year. The increase is due primarily to higher bid and proposal expenses and professional services expenses, partially offset by lower insurance expense.

The provision for asset impairment and restructuring of $52,208 in the quarter and nine months ended March 31, 2004, consists of a provision for severance benefits paid in the quarter ended March 31, 2004 related to a workforce reduction in January 2004 of 15%, or five employees.

Interest income increased by $8,511 for the quarter and by $23,696 for the nine months ended March 31, 2005 compared to the corresponding periods of the prior year. The increase was due to the higher base of cash and cash equivalents because of proceeds received from the rights offering in July 2004.

No income tax provision was recorded in the first, second or third quarters of fiscal year 2005 or 2004 because of the losses generated in those periods.

Liquidity and Capital Resources

For the nine months ended March 31, 2005, the Company's cash and cash equivalents increased by $2,694,661 from $343,260 at June 30, 2004 to $3,037,921. The increase in cash and cash equivalents was due to receipt of gross proceeds from the rights offering of $5,256,159 less payment of offering costs of $203,598, partially offset by cash used by operating activities of $2,287,385, capital expenditures of $28,813, and an increase in other assets of $41,702.

The Company's current sources of liquidity consist of its cash and cash equivalents and accounts receivable. At March 31, 2005, the Company had $3,037,921 in cash and cash equivalents and $137,606 in accounts receivable.

The Company believes, based on its operating and strategic plans and the net proceeds received in July 2004 from its rights offering to stockholders, that it will have sufficient funds to conduct operations at least through March 31, 2006.

Contractual cash commitments for the fiscal years subsequent to March 31, 2005 are summarized as follows:

	2005	2006	Thereafter	Total
Operating leases	$ 6,030	$ 741	$ 1,853	$ 8,624
Total	$ 6,030	$ 741	$ 1,853	$ 8,624

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 nine month periods ended March 31, 2005 and 2004, warranty costs were not significant.

For the quarter ended March 31, 2005, the Company's cash used in operating activities was $779,329, compared to $753,564 for the preceding quarter ended December 31, 2004. The increase was due primarily to the lower revenues in the quarter ended March 31, 2005 compared to the quarter ended December 31, 2004.

Capital equipment expenditures during the nine months ended March 31, 2005 were $28,813, down 9.4% from the same period in 2004. Future capital expenditures will depend on future sales and the success of ongoing research and development efforts.

For the quarter ended March 31, 2005, research and development expenses were $330,743, down 12.9% from $379,518 a year earlier. The decrease reflects a shift in certain resources to customer-sponsored development efforts in the quarter (the costs of which are included in cost of goods sold), resulting in initial shipments of new products to several customers. The level of future quarterly R&D expenses will ultimately depend on the Company's assessment of new product opportunities.

During the quarter and nine months ended March 31, 2005, the Company's revenues included initial shipments to several new customers of optical lenses and instruments which utilize the Company's patent-pending micro-precision lens technology and encompass a variety of innovative techniques involving minimally invasive surgery. The Company also delivered prototypes to a new customer of specialized lens systems for use in advanced night vision applications and provided thin film coatings to two other new customers for use in environmental monitoring and advanced laser instrumentation applications. These new initiatives accounted for approximately 15% of total Company revenues in each of the quarter and nine months ended March 31, 2005.

Trends and Uncertainties That May Affect Future Results

The Company expects its recent pattern of quarter-to-quarter revenue fluctuations to continue, due to the uncertain timing or 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 prototype 2.7 mm endoscope, and new instruments utilizing the Company's new micro-precisionTM lens technology (patent pending) for endoscopes under 1 mm. The Company continues to explore potential applications of single-molecule technology and nanotechnology, as well as potential near-term applications of the Company's existing technologies in non-medical markets.

The Company believes that the recent introduction of several new products, along with new and ongoing customer relationships, may 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.

Section 404 of the Sarbanes-Oxley Act of 2002, requiring companies and their public accounting firms to report on the effectiveness of the company's internal controls over financial reporting, will first apply to the Company's Annual Report on Form 10-KSB for the fiscal year ending June 30, 2007. The Company expects its operating expenses will increase as a result of the costs associated with the implementation of and maintaining compliance with Section 404.

Item 3 Controls and Procedures

As of the end of the period covered by this quarterly report, the Company's Chief Executive Officer and Principal Financial Officer have conducted an evaluation of the Company's disclosure controls and procedures. Based on their evaluation, the Company's Chief Executive Officer and Principal 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 (i) recorded, processed, summarized and reported within the time periods specified in the applicable Securities and Exchange Commission rules and forms and (ii) accumulated and communicated to the Company's management, including the Company's Chief Executive Officer and the Company's Principal Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

There was no change in the Company's internal control over financial reporting during the Company's most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Items 1-5 Not Applicable.

Item 6 Exhibits

Exhibit 31.1 – Certifications 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.

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: May 10, 2005

By: /s/ JACK P. DREIMILLER

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

EXHIBIT INDEX

Exhibit 31.1 – Certifications 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