

PRECISION OPTICS CORPORATION INC
Form 10-Q
February 17, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended December 31, 2008

or

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

For the transition period from to

Commission File Number 001-10647

PRECISION OPTICS CORPORATION, INC.

(Exact name of registrant as specified in its charter)

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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
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 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 No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company)

Smaller reporting company

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

The number of shares outstanding of issuer's common stock, par value \$0.01 per share, at February 10, 2009 was 1,018,411 shares.

PART I. FINANCIAL INFORMATION**Item 1. Financial Statements.****PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****(UNAUDITED)**

	December 31, 2008	June 30, 2008
<u>ASSETS</u>		
CURRENT ASSETS		
Cash and Cash Equivalents	\$ 339,124	\$ 885,988
Accounts Receivable, net	679,347	387,224
Inventories, net	626,660	608,431
Prepaid Expenses	52,417	36,749
Total Current Assets	1,697,548	1,918,392
PROPERTY AND EQUIPMENT		
Machinery and Equipment	2,352,634	2,352,634
Leasehold Improvements	553,596	553,596
Furniture and Fixtures	149,738	149,738
Vehicles	42,343	42,343
	3,098,311	3,098,311
Less: Accumulated Depreciation	(2,954,449)	(2,935,922)
Net Property and Equipment	143,862	162,389
OTHER ASSETS		
Cash surrender value of life insurance policies	5,465	5,465
Patents, net	186,415	195,391
Total Other Assets	191,880	200,856
TOTAL ASSETS	\$ 2,033,290	\$ 2,281,637
<u>LIABILITIES AND STOCKHOLDERS' EQUITY</u>		
CURRENT LIABILITIES		
Accounts Payable	\$ 416,356	\$ 364,409
Customer Advances	12,393	91,105
Accrued Employee Compensation	370,518	293,497
Accrued Professional Services	38,927	94,312
Accrued Warranty Expense	25,000	25,000
Other Accrued Liabilities		912
Total Current Liabilities	863,194	869,235
10% Senior Secured Convertible Notes	334,354	10,304
STOCKHOLDERS' EQUITY		
Common Stock, \$0.01 par value - Authorized - 50,000,000 shares		
Issued and Outstanding 1,018,411 shares at December 31, 2008 and at June 30, 2008	10,184	10,184
Additional Paid-in Capital	38,184,107	38,149,655
Accumulated Deficit	(37,358,549)	(36,757,741)
Total Stockholders' Equity	835,742	1,402,098
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 2,033,290	\$ 2,281,637

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

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE THREE AND SIX MONTHS ENDED

DECEMBER 31, 2008 AND 2007

(UNAUDITED)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2008	2007	2008	2007
Revenues	\$ 960,714	\$ 579,633	\$ 1,620,449	\$ 1,681,361
Cost of Goods Sold	470,429	489,607	826,026	1,285,041
Gross Profit	490,285	90,026	794,423	396,320
Research and Development Expenses, net	139,070	241,962	315,680	544,395
Selling, General and Administrative Expenses	387,982	544,512	759,931	1,020,024
Total Operating Expenses	527,052	786,474	1,075,611	1,564,419
Operating Loss	(36,767)	(696,448)	(281,188)	(1,168,099)
Interest Income	1,479	2,988	4,430	7,791
Interest Expense	(138,575)		(324,050)	
Net Loss	\$ (173,863)	\$ (693,460)	\$ (600,808)	\$ (1,160,308)
Loss Per Share - Basic and Diluted	\$ (0.17)	\$ (0.68)	\$ (0.59)	\$ (1.14)
Weighted Average Common Shares Outstanding - Basic and Diluted	1,018,411	1,018,411	1,018,411	1,018,411

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

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE SIX MONTHS ENDED

DECEMBER 31, 2008 AND 2007

(UNAUDITED)

	Six Months Ended December 31,	
	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net Loss	\$ (600,808)	\$ (1,160,308)
Adjustments to Reconcile Net Loss to Net Cash Used In Operating Activities -		
Depreciation and Amortization	32,565	106,686
Stock-based Compensation Expense	34,452	61,738
Non-cash Interest Expense	324,050	
Changes in Operating Assets and Liabilities-		
Accounts Receivable, net	(292,123)	500,966
Inventories	(18,229)	224,853
Prepaid Expenses	(15,668)	(34,469)
Accounts Payable	51,947	(97,674)
Customer Advances	(78,712)	
Other Accrued Expenses	20,724	(84,797)
Net Cash Used In Operating Activities	(541,802)	(483,005)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of Property and Equipment		(22,306)
Increase in Other Assets	(5,062)	(28,177)
Net Cash Used In Investing Activities	(5,062)	(50,483)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(546,864)	(533,488)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	885,988	840,179
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 339,124	\$ 306,691
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash Paid for-Income Taxes	\$ 912	\$ 912

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

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. All shares and per share data reflect the one-for-twenty-five reverse stock split that became effective on December 11, 2008.

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 of the Company's fiscal year 2009. 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, 2008 together with the Report of Independent Registered Public Accounting Firm filed under cover of the Company's 2008 Annual Report on Form 10-K.

The Company has sustained recurring net losses and negative cash flows from operations for several years. During the six months ended December 31, 2008, the Company incurred a net loss of \$600,808 and used cash in operations of \$541,802. As of December 31, 2008, cash and cash equivalents were \$339,124, accounts receivable were \$679,347 and current liabilities were \$863,194. These factors raise substantial doubt about the Company's ability to continue as a going concern. The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts and classification of liabilities that might be necessary should the Company be unable to continue as a going concern. During the latter part of fiscal year 2008, the Company implemented plans to reduce costs and to streamline operations in an effort to reduce net losses. This has resulted in an increase in gross profit and simultaneous decreases in operating expenses, thereby reducing losses substantially. 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 has incurred quarter to quarter operating losses during its recent efforts to develop current products including endoscopes, image couplers, beamsplitters, thin film coatings, night vision and micro-optic lenses, prisms and assemblies for various applications and utilizing a number of proprietary and patent-pending technologies including Lenslock™ endoscope and micro-precision™ lens technologies. Management expects that such operating losses will continue through fiscal year 2009, and until sales increase to breakeven and profitable levels. Management also believes that the opportunities represented by these products have the potential to generate sales increases to achieve breakeven and profitable results. The Company will continue its review of other expense areas to determine where additional reductions in discretionary spending can be achieved. There can be no assurance that the Company's operating plans will be successful, and if so required, that the Company will be successful in obtaining the capital necessary to continue ongoing operations.

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In June 2008, the Company issued \$600,000 of Senior Secured Convertible Notes and warrants to purchase an aggregate of 316,800 shares of common stock at an exercise price of \$1.75 per share, raising cash proceeds of \$600,000. In February 2007, the Company completed a private placement, pursuant to which it sold an aggregate of 400,000 shares of common stock and warrants to purchase an aggregate of 400,000 shares of common stock at an exercise price of \$8.00 per share. Net cash proceeds to the Company (after offering costs of \$123,784) were \$2,376,216.

During the past year, the introduction of several new products, along with new and on-going customer relationships, has resulted in significant revenue growth. The Company believes that with continued promotion, these opportunities have the potential to continue the general trend of increasing revenues, which, along with enhanced operations are required in order for the Company to achieve profitability.

Use of Estimates

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

Loss Per Share

Basic loss per share is computed by dividing net loss by the weighted average number of shares of common stock outstanding during the period. For the three and six months ended December 31, 2008 and 2007, 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 991,800 and 502,500 for the three and six months ended December 31, 2008 and 2007, respectively.

Revenue Recognition

The Company recognizes revenue in accordance with Securities and Exchange Commission Staff Accounting Bulletin No. 104, *Revenue Recognition* (SAB No. 104) which 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 or 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.

Inventories

We provide 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

We account for impairment of long-lived assets in accordance with Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. This statement requires that long-lived assets and certain identifiable intangibles be reviewed for 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. 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. Assets to be disposed of are reported at the lower of the carrying amount or fair value less estimated costs to sell.

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

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tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

In assessing the likelihood of utilization of existing deferred tax assets, management has considered historical results of operations and the current operating environment. Based on this evaluation, a full valuation reserve has been provided for the deferred tax assets.

Stock-Based Compensation

The Company accounts for stock based compensation in accordance with SFAS No. 123(R), *Accounting for Stock-Based Compensation* (SFAS No. 123(R)), which requires the measurement and recognition of all compensation costs for all stock-based awards made to employees and the Board of Directors based upon fair value over the requisite service period for awards expected to vest.

SFAS 123(R) requires us to estimate the fair value of stock-based awards on the date of grant using an option-pricing model. The Company adopted SFAS 123(R) using the modified prospective transition method which required the application of the accounting standard starting July 1, 2006, the first day of the Company's fiscal year 2007. Prior period information has not been restated to reflect the fair value method of expensing stock-based awards.

Recent Accounting Pronouncements

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles* (SFAS No. 162). SFAS No. 162 identifies the sources of accounting principles and provides entities with a framework for selecting the principles used in preparation of financial statements that are presented in conformity with GAAP. The current GAAP hierarchy has been criticized because it is directed to the auditor rather than the entity, it is complex, and it ranks FASB Statements of Financial Accounting Concepts, which are subject to the same level of due process as FASB Statements of Financial Accounting Standards, below industry practices that are widely recognized as generally accepted but that are not subject to due process. The FASB believes the GAAP hierarchy should be directed to entities because it is the entity (not its auditors) that is responsible for selecting accounting principles for financial statements that are presented in conformity with GAAP. The adoption of FASB 162 is not expected to have any impact on the Company's financial position.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* (SFAS No. 161). SFAS No. 161 requires additional disclosures related to the use of derivative instruments, the accounting for derivatives and how derivatives impact financial statements. SFAS No. 161 is effective for fiscal years and interim periods beginning after November 15, 2008. The adoption of SFAS No. 161 is not expected to have a material impact on our consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* (SFAS No. 141(R)), which replaces SFAS No. 141. SFAS No. 141(R) establishes principles and requirements for how an acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any controlling interest; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS No. 141(R) is to be applied prospectively to business combinations for which the acquisition date is on or after an entity's fiscal year that begins after December 15, 2008; July 1, 2009 for the Company. The impact of this Statement on the Company's financial position, results of operations and cash flows will be dependent on the terms, conditions and details of such acquisitions.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS No. 157), which provides a single definition of fair value, and requires additional disclosure about the use of fair value to measure assets and liabilities. SFAS No. 157 emphasizes that fair value is a market-based measurement defined as the price that would be received to sell an asset or liability in an orderly transaction between market participants at the measurement date. Thus, SFAS No. 157 adheres to a definition of fair value based upon exit price as opposed to entry price, i.e. the price paid to acquire an asset or liability. This pronouncement is effective for fiscal years beginning after November 15, 2007; July 1, 2008 for the Company. The Company is in the process of evaluating the impact of this authoritative guidance on its consolidated financial statements.

2. INVENTORIES

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

	December 31, 2008		June 30, 2008
Raw Materials	\$ 432,575	\$	347,298
Work-In-Progress	143,444		177,464
Finished Goods	50,641		83,669

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Total Inventories \$ 626,660 \$ 608,431

3. 10% SENIOR SECURED CONVERTIBLE NOTES

The 10% Senior Secured Convertible Notes consist of the following:

	December 31, 2008	June 30, 2008
10 % Senior Secured Convertible Notes issued on June 25, 2008, convertible into common stock at \$1.25 per share, bearing interest at 10% per annum. Outstanding principal and accrued interest are due at maturity, June 25, 2010.	\$ 600,000	\$ 600,000
Accrued interest 10% coupon	30,833	833
Unamortized discount	(296,479)	(590,529)
	\$ 334,354	\$ 10,304

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In June 2008, the Company issued Senior Secured Convertible Notes and Warrants, raising cash proceeds of \$600,000. The proceeds were allocated between the Notes and Warrants based on relative fair values. The value of the Warrants was recorded as a discount to the Notes, with a corresponding increase to additional paid-in capital. The fair value of the Warrants was determined using the Black-Scholes method, with the following assumptions:

Expected life	7 years
Risk-free rate	4.84%
Expected Dividends	0.00%
Volatility factor	154%

In accordance with EITF 00-27, *Application of EITF Issue No. 98-5, Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios*, the proceeds from the issuance of the 10% Senior Secured Convertible Notes were first allocated between the Notes and the Warrants. The value of the conversion feature was then calculated, which resulted in an effective conversion ratio that was less than the market price of the Company's common stock. The intrinsic value of this beneficial conversion feature was recorded as a further discount to the Notes, equal to the difference between the effective conversion ratio and the market price of the Company's common stock, with a corresponding increase to additional paid-in capital.

The following summarizes the discount on 10% Senior Secured Convertible Notes:

	December 31, 2008	June 30, 2008
Discount beginning balance	\$ 590,529	\$
Proceeds allocated to warrants		399,000
Beneficial conversion feature intrinsic value		201,000
Less: amortization of discount	(294,050)	(9,471)
Discount ending balance	\$ 296,479	\$ 590,529

4. STOCK-BASED COMPENSATION

Stock-based compensation costs recognized during the three and six month periods ended December 31, 2008 amounted to \$20,392 and \$34,452, respectively, and for the three and six month periods ended December 31, 2007 amounted to \$34,264 and \$61,738, respectively, and was included in the accompanying consolidated statements of operations. No compensation has been capitalized because such amounts would have been immaterial. There was no net income tax benefit recognized related to such compensation for the three and six month periods ended December 31, 2008 and 2007, as the Company is currently in a loss position. The total number of options granted during the three and six month periods ended December 31, 2008 were 1,200 and 1,200, respectively.

As of December 31, 2008, the unrecognized compensation costs related to options vesting will be primarily recognized over a period of approximately 3 years:

OPTIONS	2009	2010	2011	Total
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Compensation Expense	\$	37,896	\$	12,703	\$	12,703	\$	63,302
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	Six Months Ended	
	December 31, 2008	December 31, 2007
<u>Assumptions:</u>		
Option life	5.3 years	5.3 years
Risk-free interest rate	2.06%	4.84%
Stock volatility	179%	147%
Dividend yield	-0-	-0-
Weighted average fair value of grants	\$ 1.25	\$ 7.75

The following tables summarize stock option activity during the first six months of fiscal year 2009:

	Number of Shares	Options Outstanding Weighted Average Exercise Price	Weighted Average Contractual Life
Outstanding at June 30, 2008	97,232	\$ 15.75	7.56 years
Grants	1,200	1.25	
Exercises			
Cancellations	(5,254)	6.50	
Outstanding at December 31, 2008	93,178	\$ 16.17	\$ 7.06 years

Information related to the stock options outstanding as of December 31, 2008 is as follows:

Range of Exercise Prices	Number of Shares	Weighted-Average Remaining Contractual Life (years)	Weighted-Average Exercise Price	Exercisable Number of Shares	Exercisable Weighted-Average Exercise Price
\$1.25	1,200	9.91	\$ 1.25	1,200	\$ 1.25
\$6.25	1,600	7.92	6.25	1,600	6.25
\$7.75	1,200	8.91	7.75	1,200	7.75
\$11.50	800	6.92	11.50	800	11.50
\$13.75	51,018	7.36	13.75	39,770	13.75
\$20.75	37,360	6.46	20.75	37,360	20.75
\$1.25-\$20.75	93,178	7.06	\$ 16.17	81,930	\$ 16.50

The aggregate intrinsic value of the Company's in-the-money outstanding and exercisable options as of June 30, 2008 was \$0 and \$0, respectively, and as of December 31, 2008 was \$0 and \$0, respectively.

5. STOCKHOLDERS' EQUITY

Registration Statement

On December 18, 2008, the Company filed a registration statement on Form S-1 to register the disposition by selling stockholders of 1,074,621 shares of common stock, which included 480,000 shares underlying convertible promissory notes, 96,000 shares underlying potential interest due on the notes and 498,621 shares underlying warrants. The Company will not receive any proceeds from the sale or other disposition of common stock by the selling stockholders. The Company may receive proceeds from the exercise of warrants. As of February 13, 2009, the registration statement has not yet been declared effective by the U.S. Securities and Exchange Commission.

Reverse Stock Split

Effective as of the open of business on December 11, 2008, the Company effected a reverse stock split of its common stock, par value \$0.01 per share. Every twenty-five shares of common stock were reclassified and combined into one share of common stock, and the Company's stock ticker symbol on the OTCBB was changed from POCI.OB to PEYE.OB. No fractional shares were issued as a result of the reverse stock split. Instead, each resulting fractional share of common stock was rounded up to one whole share. The reverse stock split reduced the number of shares of common stock outstanding from 25,458,212 to 1,018,411. The total number of authorized shares of common stock continued to be 50,000,000 and the par value per share of the common stock continued to be \$0.01.

All shares and per share data in the accompanying consolidated financial statements reflect the effects of the 1-for-25 reverse stock split that became effective on December 11, 2008. In addition, capital stock has been decreased by \$244,398, with a corresponding increase to paid-in capital to reflect the adjusted number of shares of \$0.01 par value common stock outstanding as a result of the 1-for-25 reverse stock split.

Warrants

In conjunction with the sale of the 10% Senior Secured Convertible Notes on June 25, 2008 mentioned above, the Company issued warrants to purchase an aggregate of 316,800 shares of common stock at an exercise price of \$1.75 per share. The warrants became exercisable on December 11, 2008 and expire on June 25, 2015.

On February 1, 2007, the Company sold an aggregate of 400,000 shares of common stock, par value \$0.01 per share, at a price of \$6.25 per share and warrants to purchase an aggregate of 400,000 shares of common stock at an exercise price of \$8.00 per share, which were immediately exercisable, raising gross proceeds of \$2,500,000. In conjunction with the issuance by the Company of senior convertible notes and warrants on June 25, 2008, certain anti-dilution provisions of the existing warrants were triggered. As a result, the number of existing warrants was increased from 400,000 to 581,821 and the related exercise price was decreased from \$8.00 per share to \$5.50 per share.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Important Factors Regarding Forward-Looking Statements

This quarterly report on Form 10-Q contains forward-looking statements that involve risks and uncertainties. You should not place undue reliance on these forward-looking statements. Our actual results could differ materially from those anticipated in the forward-looking statements for many reasons, including the risks described in this report and other reports we file with the Securities and Exchange Commission. Although we believe the expectations reflected in the forward-looking statements are reasonable, they relate only to events as of the date on which the statements are made. We do not intend to update any of the forward-looking statements after the date of this document to conform these statements to actual results or to changes in our expectations, except as required by law.

The following discussion and analysis should be read in conjunction with the Financial Statements and Notes thereto, and other financial information included elsewhere in this quarterly report on Form 10-Q.

Overview

We have been a developer and manufacturer of advanced optical instruments since 1982. We design and produce high-quality micro-optics, medical instruments and other advanced optical systems. Our 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.

We are currently developing specialty instruments incorporating our Lenslock™ technology (patent pending) that ensures lower cost, easier reparability and enhanced durability as compared to other design approaches used in the industry. We are also aggressively pursuing ultra-small instruments, some with lenses less than one millimeter in diameter, utilizing micro-precision™ lens technology (patent pending).

We are certified to the ISO 9001 and ISO 13485 Quality Standards and comply with the FDA Good Manufacturing Practices and the European Union Medical Device Directive for CE marking of our medical products. Our internet website is www.poci.com. Information contained on our website does not constitute part of this quarterly report.

The areas in which we do business are highly competitive and include both foreign and domestic competitors. Many of our competitors are larger and have substantially greater resources than we do. Furthermore, other domestic or foreign companies, some with greater financial resources than we have, may seek to produce products or services that compete with ours. We routinely outsource specialized production efforts as required, both domestic and offshore, to obtain the most cost effective production. Over the years, we have achieved extensive experience with other optical specialists worldwide.

Since the 1990s we have maintained a Hong Kong subsidiary to support business and quality control activities as required throughout Asia. We believe that the cost savings from such production is essential to our ability to compete on a price basis in the medical products area. We believe that competition for sales of our medical products and services, which have been principally sold to original equipment manufacturer, or 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.

We believe that our future success depends to a large degree on our 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, we expect to continue to seek to obtain product-related design and development contracts with customers and to invest our own funds on research and development, to the extent funds are available.

Critical Accounting Policies and Estimates

General

Management's discussion and analysis of financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America, referred to as U.S. GAAP. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. We base our 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.

There have been no significant changes in the critical accounting policies disclosed in our Annual Report on Form 10-K for the year ended June 30, 2008.

Results of Operations

During the latter part of fiscal year 2008, we implemented plans to reduce costs, including workforce reductions, to focus sales efforts on higher margin products, and to streamline operations in an effort to reduce net losses. These efforts, combined with recent increases in sales, resulted in an increase in gross profit and a simultaneous decrease in operating expense beginning in the third quarter of fiscal year 2008 and continuing with the first half of fiscal year 2009. Excluding the effect of the gain on sale of product line in January 2008, operating loss for the quarter ended December 31, 2008 was the lowest of any quarter in the last twelve years. We anticipate continuing the measures taken to contain costs, and to continue our review of other expense areas to determine where additional reductions in spending can be achieved.

Our total revenues for the quarter ended December 31, 2008, the second quarter of our fiscal year 2009, were \$960,714, an increase of \$381,081 or 65.7% from the same period last year. Our total revenues for the six months ended December 31, 2008 were \$1,620,449, a decrease of \$60,912 or 3.6% from the same period last year. The increase in revenues for the current quarter was due principally to increases in sales of new optical components and fiber scopes utilizing our micro-precision™ lens and prism technology beginning in the quarter ended September 30, 2008 and resumption of shipments of an advanced surgical visualization system. The decrease in revenues for the six months ended December 31, 2008 was due principally to shipments to a significant new customer of an advanced surgical visualization system last year, partially offset by sales of the new optical components and fiber scopes. Although there were no shipments of the advanced surgical visualization system in the quarter ended September 30, 2008, we resumed shipments of this product in the quarter ended December 31, 2008.

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Revenues from our largest customers, as a percentage of total revenues, for the six months ended December 31, 2008 and 2007, were as follows:

	2008	2007
Customer A	30%	9%
Customer B	18	16
Customer C	11	7
Customer D	7	38
All Others	34	30
	100%	100%

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

Gross profit for the quarter ended December 31, 2008 was \$490,285, which reflects an increase of \$400,259, compared to the quarter ended December 31, 2007. Gross profit for the quarter ended December 31, 2008 as a percentage of revenues increased from 15.5% for the quarter ended December 31, 2007 to 51.0% in the current quarter. Gross profit for the six months ended December 31, 2008 was \$794,423, which reflects an increase of \$398,103, compared to the six months ended December 31, 2007. Gross profit for the six months ended December 31, 2008 as a percentage of revenues increased from 23.6% for the six months ended December 31, 2007 to 49.0% in the current year. The favorable change in our gross profit percentage was due primarily to increased manufacturing efficiencies, favorable change in product mix and certain cost containment plans implemented in fiscal year 2008 as discussed above.

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Research and development expenses were \$139,070 for the quarter ended December 31, 2008, compared to \$241,962 for the same period last year, a reduction of \$102,892 or 42.5%. Research and development expenses were \$315,680 for the six months ended December 31, 2008, compared to \$544,395 for the same period last year, a reduction of \$228,715 or 42.0%. The decrease was due primarily to the implementation of certain cost containment plans in fiscal year 2008 including workforce reductions, deferment of certain development initiatives, increased reimbursements from customers for product development activities and increased focus on a limited number of products and technologies expected to provide near term revenues. Quarterly research and development expenses depend on our assessment of new product opportunities and available resources. Research and development expenses were net of reimbursement of related costs of \$168,856 and \$18,693 during the quarters ended December 31, 2008 and 2007, respectively.

Selling, general and administrative expenses were \$387,982, a decrease of \$156,530, or 28.7%, for the quarter ended December 31, 2008 compared to the same period last year. Selling, general and administrative expenses were \$759,931, a decrease of \$260,093, or 25.5%, for the six months ended December 31, 2008 compared to the same period last year. The decrease was due primarily to the implementation of certain cost containment plans in fiscal year 2008 including workforce reductions, as mentioned above. This was partially offset by higher nonrecurring legal, accounting and transfer agent fees amounting to approximately \$57,000 recorded in the quarter ended December 31, 2008, related to the preparation and filing of a registration statement and implementation of a 1-for-25 reverse stock split in December 2008, as contractually required by the June 2008 financing transaction. Without these unusual nonrecurring expenses, our operating profit would have been positive for the quarter ended December 31, 2008.

Interest income decreased by \$1,509 and \$3,361, respectively, for the quarter and six months ended December 31, 2008 compared to the same period last year. The decrease was due to a lower base of cash and cash equivalents.

Interest expense increased by \$138,575 and \$324,050, respectively, for the quarter and six months ended December 31, 2008 compared to the same period last year. The increase was due to the accrual of non-cash interest expense (including the amortization of debt discount) on the 10% Senior Secured Convertible Notes issued on June 25, 2008.

No income tax provision was recorded in the second quarter of fiscal year 2009 or 2008 because of the losses generated in those periods.

Liquidity and Capital Resources

We compete in a highly technical, very competitive, and in most cases, price driven segment of the medical instrument marketplace where products can take years to develop and introduce to distributors and end users. Furthermore, research and development, manufacturing, marketing and distribution activities are strictly regulated by FDA, ISO and other regulatory bodies that, while intended to enhance the ultimate quality and functionality of products produced, can contribute to the significant cost and time needed to maintain existing products and develop and introduce product enhancements and new product innovations.

We have traditionally funded working capital needs through product sales, management