PRECISION OPTICS CORPORATION INC
Form 10QSB
May 15, 2001

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, 2001

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 ( )

The number of shares outstanding of issuer's common stock, par value $.01 per share, at March 31, 2001 was 10,498,908 shares.

Transitional Small Business Disclosure Format (check one):

Yes ( ) No (X)

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

MARCH 31, 2001

ASSETS

CURRENT ASSETS	
Cash and Cash Equivalents	$12,058,336
Accounts Receivable, Net	752,643
Inventories	1,314,282
Prepaid Expenses	240,570
Total Current Assets	14,365,831
PROPERTY AND EQUIPMENT	9,097,874
Less: Accumulated Depreciation	(3,487,071)
Net Property and Equipment	5,610,803
OTHER ASSETS	257,456
TOTAL ASSETS	$20,234,090

LIABILITIES AND STOCKHOLDERS' EQUITY

CURRENT LIABILITIES	
Accounts Payable	$ 306,825
Accrued Payroll	94,551
Accrued Professional Services	62,707
Accrued Profit Sharing and Bonuses	11,250
Accrued Income Taxes	--
Accrued Vacation	111,634
Accrued Warranty Expense	50,000
Current Portion of Capital Lease Obligation	50,486
Other Accrued Liabilities	75,220
Total Current Liabilities	762,673
CAPITAL LEASE OBLIGATION AND OTHER	87,229
STOCKHOLDERS' EQUITY	
Common Stock, $.01 par value -- Authorized -- 20,000,000 shares Issued and Outstanding -- 10,498,908 and 10,285,158 shares at March 31, 2001 June 30, 2000, respectively	104,989
Additional Paid-in Capital	27,638,474
Accumulated Deficit	(8,359,275)
Total Stockholders' Equity	19,384,188
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$20,234,090

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE THIRD QUARTER AND NINE MONTHS ENDED

MARCH 31, 2001 AND 2000

	--THIRD QUARTER-- 2001 (UNAUDITED)	2000 (UNAUDITED)	--NIN 2001 (UNAUDITED)
REVENUES	$1,133,984	$784,503	$2,800,817
COST OF GOODS SOLD	920,578	595,472	2,099,185
GROSS PROFIT	213,406	189,031	701,632
RESEARCH and DEVELOPMENT EXPENSES	878,715	442,835	2,216,164
SELLING, GENERAL and ADMINISTRATIVE EXPENSES	629,456	457,823	1,528,006
TOTAL	1,508,171	900,658	3,744,170
OPERATING LOSS	(1,294,765)	(711,627)	(3,042,538
INTEREST EXPENSE	(2,544)	(6,537)	(9,640
INTEREST INCOME	186,361	50,502	649,345
NET LOSS	$(1,110,948)	$(667,662)	$(2,402,833
BASIC AND DILUTED LOSS PER SHARE	($0.11)	($0.08)	($0.23
BASIC AND DILUTED WEIGHTED AVERAGE COMMON SHARES OUTSTANDING	10,498,908	8,471,946	10,464,586

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PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE NINE MONTHS ENDED
MARCH 31, 2001 AND MARCH 31, 2000
(UNAUDITED)

	2001	2

CASH FLOWS FROM OPERATING ACTIVITIES:		
Net Loss	$ (2,402,833)	$ (1,
Adjustments to Reconcile Net Loss to Net Cash Used In Operating Activities –		
Depreciation and Amortization	624,477	
Non-Cash Royalty Expense	--	
Changes in Assets and Liabilities–		
Accounts Receivable	(114,344)	(
Inventories	(204,771)	
Prepaid Expenses	(169,763)	(
Accounts Payable	(12,271)	
Accrued Expenses	63,972	
Net Cash Used In Operating Activities	(2,215,533)	(1,
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of Property and Equipment	(3,328,961)	(
Increase in Other Assets	(25,948)	
Net Cash Used in Investing Activities	(3,354,909)	(
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayment of Capital Lease Obligation	(83,746)	(
Net proceeds from litigation settlement	2,368,485	
Net Proceeds (Costs) From Private Placement of Common Stock	(16,921)	15,
Proceeds from Exercise of Stock Options and Warrants	232,210	3,
Net Cash Provided By Financing Activities	2,500,028	18,
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(3,070,414)	16,
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	15,128,750	
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 12,058,336	$ 16,
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash Paid for–		
Interest	$ 9,640	$
Income Taxes	$ --	$
SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING AND FINANCING ACTIVITIES:		
Capital Lease Obligation	$ --	$

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 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 2001. These financial statements do not include all disclosures associated with annual financial statements and, accordingly, should be read in conjunction with footnotes contained in the Company's financial statements for the period ended June 30, 2000 together with the auditors' report filed under cover of the Company's 2000 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 nine months ended March 31, 2001 and 2000, 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 that were excluded from the computation as their effect would be antidilutive were 1,217,598 and 1,864,648 for the nine months ended March 31, 2001 and 2000, respectively.

2. INVENTORIES

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

	MARCH 31, 2001	JUNE
Raw Materials	$775,112	$
Work-In-Process	387,704	
Finished Goods and Components	151,466	
Total Inventories	$1,314,282	$1,

3. NEW ACCOUNTING STANDARDS

In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin (SAB) No. 101, REVENUE RECOGNITION IN FINANCIAL STATEMENTS. In June 2000, this SAB was amended by SAB 101B, which delayed the implementation date of SAB 101 until the fourth fiscal quarter of fiscal years beginning after December 15, 1999. SAB 101 provides additional guidance on the accounting for revenue recognition, including both generally applicable, as well as certain industry-specific, guidance. The Company adopted SAB 101 as of July 1, 2000, which had no impact on the Company's previously reported results.

On July 1, 2000, the Company adopted SFAS No. 133, ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES. This statement, as amended by SFAS No. 137 and 138, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. The adoption of this new standard has not had a significant impact on the Company's consolidated financial statements based on its current structure and operations.

As of December 31, 2000, in accordance with EMERGING ISSUES TASK FORCE (EITF) ISSUE NO. 00-19, ACCOUNTING FOR DERIVATIVE FINANCIAL INSTRUMENTS INDEXED TO, AND POTENTIALLY SETTLED IN, A COMPANY'S OWN STOCK, the Company has reclassified the fair value of outstanding non-employee options to purchase 25,000 shares of common stock of the Company from stockholders' equity to a liability category. The fair value of such options totals approximately $37,000 and has been included under the "Capital Lease Obligation and Other" caption of the Company's consolidated balance sheet as of March 31, 2001.

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", "expects," 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, the uncertainty and timing of the successful development of the Company's new products, particularly in the optical thin films area; the risks associated with reliance on a few key customers; 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; performance by the Company's vendors; the ability of the Company to control costs associated with performance under fixed price contracts; 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.

LIQUIDITY AND CAPITAL RESOURCES

For the nine months ended March 31, 2001, the Company's cash and cash equivalents decreased by approximately $3,070,000 to $12,058,000. The decrease in cash and cash equivalents was due to cash used by operating activities of approximately $2,215,000, capital expenditures of approximately $3,329,000, repayment of capital lease obligations of approximately $84,000, expenses of approximately $17,000 associated with a private placement of common stock in fiscal year 2000, and an increase in other assets (primarily patents) of approximately $26,000, partially offset by net proceeds received of approximately $2,369,000 from settlement of litigation and proceeds received of approximately $232,000 from exercise of stock options and warrants.

The Company intends to continue devoting significant 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 and optical thin films product lines, and the development of new methods of distribution.

The Company's cash and cash equivalents are considered sufficient to support working capital and investment needs for at least the next twelve months.

RESULTS OF OPERATIONS

Total revenues for the quarter and nine months ended March 31, 2001 increased by $349,481 or 44.5% and $712,026 or 34.1%, respectively, from the same periods in the prior year.

The revenue increase from the prior year for the third quarter was due to higher sales of medical products (up 19%), and higher sales of non-medical products (up 400%). For the quarter ending March 31, 2001, medical sales were higher due primarily to higher shipments of stereo endoscopes and endoscopic cameras. Non-medical sales were higher for the quarter due primarily to higher sales of Dense Wavelength Division Multiplexing (DWDM) filters and initial sales of DWDM filter test instrumentation.

The revenue increase from the prior year for the nine months ended March 31, 2001 was due to higher sales of medical products (up 16%), and higher sales of non-medical products (up 186%). For the nine months ended March 31, 2001, medical sales were higher due primarily to higher sales of stereo endoscopes and endoscopic cameras, and non-stereo endoscopes. Non-medical sales were higher year to date due primarily to higher sales of DWDM filters and initial sales of DWDM test instrumentation.

Revenues from the Company's single largest customer were approximately 48% of total revenues for the nine months ended March 31, 2001, and revenues from the Company's two largest customers, were approximately 48% and 11% of total revenues for the nine months ended March 31, 2000. No other customers accounted for more than 10% of the Company's revenues during those periods.

Gross profit expressed as a percentage of revenues decreased from 24.1% to 18.8% for the third quarter, and decreased from 34.3% to 25.1% for the nine months ended March 31, 2001, compared to the corresponding periods in the prior year. The decrease in the gross profit percentage was due primarily to higher fixed manufacturing costs such as depreciation, insurance, operating supplies, equipment and building rent, utilities, and indirect labor and benefits, and lower average selling prices for DWDM filters.

Research and development expenses increased by approximately $436,000, or 98%, for the quarter ending March 31, 2001, and by approximately $917,000, or 71%, for the nine months ending March 31, 2001 compared to the corresponding periods of the prior year. During both years, internal research and development expenses consisted primarily of development efforts related to DWDM filters used in telecommunications systems. The increase was due to more resources being devoted to the DWDM filter project in the current year, and to the commencement of product development efforts on a new product line - filter test equipment.

Selling, general and administrative expenses increased by approximately $172,000, or 37.5%, for the quarter ending March 31, 2001 and by approximately $247,000, or 19.3%, for the nine months ending March 31, 2001 compared to the corresponding periods of the prior year. The increase is due primarily to higher employee recruiting, insurance, depreciation,

advertising and trade show expenses, and higher provisions for estimated uncollectable customer accounts.

Interest expense relates primarily to capital lease obligations.

Interest income increased by approximately $136,000 for the quarter and by $584,000 for the nine months ending March 31, 2001 compared to the corresponding periods of the prior year due to the higher base of cash and cash equivalents related primarily to net proceeds received from a private placement of common stock in March 2000, from exercise of stock options and warrants, and from net proceeds received from settlement of litigation.

No income tax provision was recorded in fiscal year 2001 or 2000 because of the losses generated in those periods.

TRENDS AND UNCERTAINTIES THAT MAY AFFECT FUTURE RESULTS

200 GHz DWDM Filters

During the quarter ended March 31, 2001, sales of 200 GHz DWDM filters more than doubled over last year's third quarter to a record quarterly level, and represented 19.4% and 15.6%, respectively, of total revenues for the quarter and nine months ended March 31, 2001.

As previously reported, this growth had been interrupted during the previous quarter pending the renegotiation of pricing and delivery terms on several large orders amidst downward pricing pressure in the DWDM market. During the quarter ended March 31, 2001, these negotiations were successfully completed and shipments were resumed. However, one customer, who was a participant in these negotiations, and accounted for 5.7% and 3.9%, respectively, of total revenues for the quarter and nine months ended March 31, 2001, subsequently canceled the balance of its order prior to quarter end due to the loss of a contract with one of its own customers.

Production levels and yields for 200 GHz filters have continued to improve significantly. Sales this quarter through the first week of May, none of which were made in connection with the canceled order referred to above, have already exceeded filter sales for the entire quarter ended March 31, 2001. Current orders as of March 31, 2001 for 200 GHz filters totaled approximately

$885,000, with delivery scheduled during the quarters ending June and September, 2001. Discussions are now proceeding to secure new and repeat filter orders extending beyond this period.

100 GHz DWDM Filters

In late March the Company took delivery of a new state-of-the-art 100 GHz production system. Installation was completed in April, with full production and shipment of 100 GHz filters expected to begin in the quarter ending June 30, 2001.

DWDM Filter Test Instrumentation

Also in March, the Company introduced two major new products at the Optical Fiber Communication Conference (OFC) trade show -- the manual Gen III(TM) DWDM Test Fixture for characterizing telecommunications filters and a fully automated filter testing system. Both products are based on patent-pending technology and allow greatly enhanced speed and accuracy in the measurement of filters. These were received enthusiastically. Initial shipments of manual test fixtures represented 8.7% of total Company revenues for the quarter, and additional units are scheduled for delivery during the current quarter. Product development is continuing on the automated filter testing system, with initial sales anticipated during the next fiscal year.

Product and Infrastructure Development

The Company has continued to invest aggressively in research, development and capital equipment to support increased participation in the long-term opportunities the telecommunications industry offers. In particular, work has accelerated on improved, higher-capacity manufacturing processes for 200 GHz filter production, and development and commercialization of 100 GHz filters. With the installation of the 100 GHz system described above, the Company now has proprietary state-of-the-art systems in place for producing both 100 and 200 GHz filters. These systems have accounted for a substantial portion of the Company's recent research and development and capital equipment expenses. For the nine months ended March 31, 2001, R&D expenses were approximately $2.2 million (up 71% from last year), and capital equipment expenditures were approximately $3.3 million, up more than 350% from the same period last year. With a large part of the DWDM infrastructure currently in place, R&D and capital equipment expenditure increases of this magnitude are not anticipated in the foreseeable future.

Medical Products

Sales of medical products were up 19.8% over last year's third quarter, and represented 77% of total revenues for the nine months ended March 31, 2001. However, the Company's principal customer for stereo endoscopes has notified the Company that, upon completion of current orders in June 2001, it would cease placing orders for stereo endoscopes with the Company in favor of other sources of supply. Sales of stereo endoscopes to this customer amounted to 35% of total revenues for the nine months ended March 31, 2001.

Outlook

The loss of the Company's principal customer for stereo endoscopes will have an adverse impact on near-term medical sales unless these revenues are replaced. However, we are moving aggressively to offset this reduction in revenue with new product offerings to other major medical customers. One example is a new 5mm laparoscope which began shipping in April following successful prototype trials.

The Company believes that downward trends in the selling prices of both 100 GHz and 200 GHz DWDM filters may continue, due primarily to increasing competitive pressure from other filter manufacturers and softening demand experienced by telecommunications equipment providers whose products incorporate DWDM filters as integral components. To address the effects of anticipated reductions in selling prices, the Company is continuing its efforts (1) to control and reduce manufacturing costs by increasing production capacity and yields and by streamlining manufacturing processes, and (2) to complete the commercialization of 100 GHz filters, which the Company anticipates will have higher profit margins than those of the 200 GHz filters.

While the current economic slowdown has had significant impact throughout the telecommunications industry, the Company believes that its current DWDM filters and filter testing products are well positioned to help customers respond to continuing price pressures as well as long-term demand for high-performance components.

A major thrust of Company activity over the last two quarters has been the development of higher-volume, higher-yield and lower-cost production and test facilities for both 200 and 100 GHz filters. April 2001 marked the first month in which the Company attained consistent production volumes over an entire month's production, and work is continuing to improve yield per deposition run, helped by the significantly higher throughput of the Company's new manual Gen III(TM) DWDM Test Fixture, which is also generating revenue as a separate product. The automatic test system currently being integrated into production lines will enable further increases in throughput, and should begin to generate its own additional sales in the coming fiscal year. The Company believes that these developments in the DWDM area are positive indicators for near-term improvements in telecommunications-related sales.

Notwithstanding these recent and anticipated accomplishments, the long term success of the Company's DWDM filter products continues to depend upon a number of factors, including the Company's timely completion of ongoing product development efforts, continued ability to meet a set of rigorous customer specifications, ability to control and reduce manufacturing costs to generate acceptable profit margins, and success in reliably manufacturing such products in sufficient quantities at acceptable yields to meet customer demand.

PART II. OTHER INFORMATION

Items 1-5 Not Applicable.

Item 6 Exhibits and Reports on Form 8-K

(a) Exhibits -- None.

(b) Reports on Form 8-K -- The Company filed one Current Report on Form 8-K during the quarter ended March 31, 2001 as follows -- On February 8, 2001, the Company reported a press release issued February 7, 2001 reporting its operating results for the quarter ended December 31, 2000.

SIGNATURE

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 15 , 2001

BY: /s/ JACK P. DREIMILLER

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