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PRECISION OPTICS CORPORATION INC  
Form 10KSB  
September 27, 2002

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
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FORM 10-KSB

(Mark One)

ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Fiscal Year Ended JUNE 30, 2002

OR

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

For transition period from \_\_\_\_ to \_\_\_\_

Commission File Number 001-10647

PRECISION OPTICS CORPORATION, INC.  
(Name of small business issuer in its charter)

MASSACHUSETTS  
(State or other jurisdiction  
of incorporation or organization)

04-279-5294  
(I.R.S. Employer  
Identification No.)

22 EAST BROADWAY  
GARDNER, MASSACHUSETTS 01440  
(Address of principal executive offices) (Zip Code)

(978) 630-1800  
(Issuer's telephone number, including area code)

Securities registered under Section 12(b) of the Act:

NONE

Securities registered under Section 12(g) of the  
Act:

COMMON STOCK, \$.01 PAR VALUE

Check whether the issuer: (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act 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 \_\_\_

Check if no disclosure of delinquent filers in response to Item 405 of Regulation S-B is contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. X

The issuer's revenues for its most recent fiscal year were \$1,774,283.

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The aggregate market value of the voting stock, consisting solely of common stock, held by non-affiliates of the issuer computed by reference to the closing price of such stock was \$2,485,773 as of August 31, 2002.

The number of shares of outstanding common stock of the issuer as of August 31, 2002 was 10,503,908.

### DOCUMENTS INCORPORATED BY REFERENCE

The issuer's Proxy Statement for the 2002 Annual Meeting of Shareholders to be held on November 12, 2002 is incorporated into Part III of this Form 10-KSB.

### PART I

#### ITEM 1. DESCRIPTION OF BUSINESS

##### BUSINESS DEVELOPMENT

Precision Optics Corporation, Inc. (the "Company") was incorporated in Massachusetts in 1982 and has been publicly owned since November 1990.

References to the Company contained herein include its two wholly-owned subsidiaries, except where the context otherwise requires.

##### BUSINESS OF ISSUER

The Company designs, develops, manufactures and sells specialized optical systems and components and optical thin film coatings. The Company conducts business in one industry segment only. The Company's products and services fall into the following areas: medical products for use by hospitals and physicians, optical thin films used in telecommunications and other applications, test instrumentation, and advanced optical system design and development services.

##### PRINCIPAL PRODUCTS AND SERVICES AND METHODS OF DISTRIBUTION.

**MEDICAL PRODUCTS.** The Company's medical products include endoscopes, as well as image couplers, beamsplitters and adapters, all of which are used as accessories to endoscopes.

Since January 1991, the Company has developed and sold endoscopes using various optical technologies for use in a variety of minimally invasive surgical and diagnostic procedures. The Company's current line of specialized endoscopes include arthroscopes (which are used in joint surgery), laryngoscopes (which are used in the diagnosis of diseases of the larynx), laparoscopes (which are used in abdominal surgery) and stereo endoscopes and cameras (which are used in cardiac and general surgery, and enable surgeons to visualize the surgical field in 3-D imagery, thus facilitating greater finesse and minimizing surgical risk). In addition to its existing line of endoscopes, the Company is continuing to develop different types of endoscopes that incorporate varying types of construction and technology for use in various medical specialties.

In March 2002, the Company shipped the first production lot of autoclavable endoscopes to a major orthopedic equipment supplier. These new endoscopes, which are also CE Mark certified for European use, have been designed and tested to withstand sterilization by flash and standard autoclave, as well as all other commonly used medical sterilization means. The major benefits of autoclavable instruments include increased patient safety, quick

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turnaround, and elimination of hazardous sterilant and by-product materials, all of which provide a much better value to the user. The Company believes its autoclavable endoscope technology will generate significant opportunities for endoscope revenue growth, particularly in Europe where autoclaving is the preferred method of sterilization.

The Company developed and has manufactured and sold since 1985 a proprietary product line of instrumentation to couple endoscopes to video cameras. Included in this product line are imaging couplers, which physically connect the endoscope to a video camera system and transmit the image viewed through the scope to the video camera. Another product, the beamsplitter, performs the same function while preserving for the viewer an eyepoint for direct, simultaneous viewing through the endoscope. The Company has sold these devices primarily to endoscope and video camera manufacturers and suppliers for resale under the Company's customers' names.

2

The Company's image couplers and beamsplitters can withstand surgery-approved sterilization. The Company also offers autoclavable image couplers, which are able to withstand sterilization in superheated steam under pressure. Autoclavability is a preferred method of sterilization because of its relative speed, safety, and efficiency. The Company believes that it is the only company in the world that produces autoclavable image couplers.

Included in the Company's medical products sales are sales of image couplers and beamsplitters for video-monitored examination of a variety of industrial cavities and interiors. The Company has developed, and may develop in the future, specialized borescopes for industrial applications.

OPTICAL THIN FILMS. Optical thin film filters are used as the key components for devices which can separate laser communication signals into constituent wavelengths (i.e., colors) of very narrow bandwidths. By separating a communication signal into its constituent wavelengths, it is possible to create additional communication channels and thereby increase the transmission capacity of a fiber optic communication line. The technique of separating communication signals into constituent wavelengths of very narrow bandwidths to increase transmission capacity in fiber optic communication lines is called Dense Wavelength Division Multiplexing (DWDM). The devices that perform this separation technique, composed of one or more optical thin film filters and a means of being attached to a fiber optic communication line, are called Dense Wavelength Division Multiplexers. The Company's DWDM optical thin film filters are designed to withstand changes in temperature and humidity, consistent with customers' environmental requirements for passive components.

The Company also designs and manufactures various other types of high quality thin film coatings for use in a wide range of optical applications. Thin film coatings are produced in-house for the Company's medical instrumentation and other products. Presently, optical thin film manufacturing not associated with the Company's medical instruments and other products is limited or very specialized.

DWDM FILTER TEST INSTRUMENTATION. In March 2001, the Company introduced two 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.

Current business prospects for the Company's DWDM filters and DWDM test instrumentation are negligible, largely because of lack of visibility concerning

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future spending levels for telecommunications equipment. The Company believes that downward trends in the selling prices of DWDM filters may continue because of existing inventory surpluses, increasing competitive pressure, the advent of competing technologies, and erosion of demand experienced by telecommunications equipment providers. As a result of these market factors, during fiscal year 2002 the Company implemented certain cost saving measures, and recorded provisions for restructuring, inventory write-down and loss on impairment of fixed assets. Earlier in fiscal year 2002, the Company ceased operations in its Optical Thin Film Technology Center and recently entered into an agreement to terminate the lease on that facility. The property and equipment used in the facility is idle, and as of June 30, 2002, is being held for sale. However, the Company has retained and is currently utilizing certain other thin film coating equipment used for its medical products and other applications. The Company is no longer actively marketing its DWDM filters and DWDM filter test equipment. See Notes 6 and 7 of Notes to Consolidated Financial Statements.

OPTICAL SYSTEM DESIGN AND DEVELOPMENT SERVICES. The Company provides on a contract basis advanced lens design, imaging analysis, optical system design, structural design and analysis, prototype production and evaluation, optics testing, and optical system assembly. Some of the Company's development contracts have led to optical system production business for the Company, and the Company believes its prototype development service may lead to new product production from time to time.

3

### COMPETITION AND MARKETS.

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 may establish or use 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 may be 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 currently sells its image couplers, beamsplitters, and adapters to a market that consists of approximately 30 to 35 potential OEM customers. These potential customers sell video cameras, endoscopes, or video-endoscopy systems. The Company has made sales to approximately two thirds of these customers. The Company estimates that it has approximately 20% to 30% of the market share in these products. The Company's primary competition in this area is the customers' own in-house capabilities to manufacture such products. The Company believes that these customers typically purchase products from the Company, despite their in-house capabilities, because they choose to devote their own technical resources to their primary products, such as cameras or endoscopes. The Company estimates that approximately 50% of the market demand for image couplers, beamsplitters, and adapters is met by "captive" or in-house capabilities.

The Company has marketed and sold its endoscopes to OEM video camera

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and video endoscopy suppliers for resale under the purchaser's name. A number of domestic and foreign competitors also sell endoscopes to such OEM suppliers, and the Company's share of the endoscope market is nominal. The Company believes that, while its resources are substantially more limited than these competitors, the Company can compete successfully in this market on the basis of price and delivery.

The Company offers advanced optical design and development services not related to thin film coatings to a wide range of potential customers and has numerous competitors. The ability to supply design and development services to such customers is highly dependent upon a company's and its employees' reputations and prior experience.

The Company has had negligible direct export sales to date. However, during fiscal year 2002, the Company's medical products received the CE Mark Certification, which permits sales into the European marketplace.

### RESEARCH AND DEVELOPMENT.

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 its research and development. The Company spent approximately \$2,271,000 and \$3,215,000 of its own funds during fiscal years 2002 and 2001, respectively, on the Company's own research and development.

4

### RAW MATERIALS AND PRINCIPAL SUPPLIERS.

For all of the Company's products, except for thin film coatings, the basic raw material is precision grade optical glass, which the Company obtains from several major suppliers. Outside vendors grind and polish most of the Company's lenses and prisms. For optical thin film coatings, the basic raw materials are metals and dielectric compounds, which the Company obtains from a variety of chemical suppliers. Certain of the thin film coatings utilized in the Company's products are currently procured from an outside supplier, but most thin film coatings are produced in-house. The Company believes that its demand for these raw materials and thin film coating services is small relative to the total supply and that materials and services required for the production of its products are currently available in sufficient production quantities and will be available for fiscal year 2003. The Company believes, however, that there are relatively few suppliers of the high quality lenses and prisms which its endoscopes may require. The Company has therefore established an in-house optical shop for producing ultra-high quality prisms, micro-optics and other specialized optics for a variety of medical and industrial applications. Depending upon the market acceptance of the Company's endoscopes, the Company may seek to assure itself of a timely supply of lenses, prisms, or other key materials or components through the acquisition of an outside supplier or expanded in-house manufacturing facilities.

### PATENTS AND TRADEMARKS.

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 patent, patent pending, or license, although it believes that trade secrets and confidential know-how may be important to the

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Company's scientific and commercial success.

The Company plans to file for patents, copyrights, and trademarks in the United States and in appropriate countries to protect its intellectual property rights to the extent practicable. The Company holds the rights to several United States and foreign patents and has several patent applications pending. The Company knows of no infringements of its patents. The Company plans to protect its patents from infringement in each instance where it determines that doing so would be economical in light of the expense involved and the level and availability of the Company's financial resources. While the Company believes that its pending applications relate to patentable devices or concepts, there can be no assurance that patents will be issued or that any patents issued can be successfully defended or will effectively limit the development of competitive products and services.

### EMPLOYEES.

As of June 30, 2002, the Company had 38 full-time employees and 5 part-time employees. There were 22 employees in manufacturing, 12 in engineering, 3 in sales and marketing, and 6 in finance and administration.

5

### CUSTOMERS.

Revenues from the Company's largest customers, as a percentage of total revenues, were as follows:

	2001	2002
Customer A	41%	23%
Customer B	7	18
Customer C	18	6
All Others	34	53
	-----	-----
	100%	100%
	=====	=====

No other customer accounted for more than 10% of the Company's revenues in fiscal year 2001 and 2002.

### ENVIRONMENTAL PROTECTION AND THE EFFECT OF EXISTING OR PROBABLE GOVERNMENT REGULATIONS ON THE BUSINESS.

The Company's operations are subject to a variety of federal, state, and local laws and regulations relating to the discharge of materials into the environment or otherwise relative to the protection of the environment. From time to time the Company uses a small amount of hazardous materials in its operations. The Company believes that it complies with all applicable environmental laws and regulations.

### NEED FOR GOVERNMENT APPROVAL OF PRINCIPAL PRODUCTS OR SERVICES AND EFFECT OF EXISTING OR PROBABLE GOVERNMENT REGULATIONS ON THE BUSINESS.

The Company currently sells and markets several medical products, the marketing of which may require the permission of the United States Food and Drug Administration ("FDA"). Pursuant to the Company's notification to the FDA of its intent to market its endoscopes, image couplers, beamsplitters, and adapters,

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the FDA has determined that the Company may market such devices, subject to the general controls provisions of the Food, Drug and Cosmetic Act. This FDA permission was obtained without the need to undergo a lengthy and expensive approval process, on account of the FDA's determination that such devices meet the regulatory standard of being substantially equivalent to an existing approved device. Furthermore, the Company plans to market additional endoscopes and related medical products that may require the FDA's permission to market such products. The Company may also develop additional products or seek to sell some of its current or future medical products in a manner that requires the Company to obtain the permission of the FDA to market such products, as well as the regulatory approval or license of other federal, state, and local agencies or similar agencies in other countries. The FDA has authority to conduct detailed inspections of manufacturing plants in order to assure that "good manufacturing practices" are being followed in the manufacture of medical devices, to require periodic reporting of product defects to the FDA, and to prohibit the sale of devices which do not comply with law.

### ITEM 2. DESCRIPTION OF PROPERTY

The Company conducts its domestic operations at two facilities in Gardner, Massachusetts. The main Gardner facility is leased from a corporation owned by an officer-shareholder-director of the Company. The lease terminated in December 1999 and the Company is currently a tenant at will. The other Gardner facility is under a five-year lease which commenced on March 1, 1999. In August 2000, the Company entered into a five-year lease for approximately 37,400 square feet of additional space to be used for its Optical Thin Film Technology Center. Operations in the new facility commenced during the quarter ending December 31, 2000. However, currently this space is idle because of certain restructuring measures the Company undertook during

6

fiscal year 2002 due to the severe decline in the market for the Company's DWDM filters and DWDM filter test equipment. The Company entered into an agreement to terminate this lease effective September 30, 2002. 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 additions or manufacturing capabilities in connection with the production of the Company's line of endoscopes, optical thin films, and other products may, however, require the acquisition or lease of additional facilities. The Company may establish production facilities domestically or overseas to produce key assemblies or components, such as lenses, for the Company's products. Overseas facilities may subject the Company to the political and economic risks associated with overseas operations. The loss of or inability to establish or maintain such additional domestic or overseas facilities could materially adversely affect the Company's competitive position and profitability.

### ITEM 3. LEGAL PROCEEDINGS

None.

### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of the Company's security holders during the fourth quarter of fiscal year 2002.

DIRECTORS AND EXECUTIVE OFFICERS OF THE COMPANY

The Company's executive officers and directors are as follows:

NAME	POSITION WITH THE COMPANY OR PRINCIPAL OCCUPATION
Richard E. Forkey	Chairman of the Board, Chief Executive Officer, President, Treasurer and Director
Jack P. Dreimiller	Senior Vice President, Finance, Chief Financial Officer and Clerk
Edward A. Benjamin	Director and Member of Audit Committee. Mr. Benjamin is a retired partner in the law firm of Ropes & Gray, Boston, Massachusetts.
H. Angus Macleod	Director. Dr. Macleod is President of the Thin Film Center, Inc. of Tucson, Arizona, which provides software consulting and courses for design and analysis of thin film optical coatings and filters.
Austin W. Marxe	Director. Mr. Marxe is Managing Director of Special Situations Fund III, L.P., a registered investment company based in New York City, and several other affiliated investment funds.
Joel R. Pitlor	Director and Member of Audit Committee. Mr. Pitlor is president of J.R. Pitlor, a management consulting firm based in Cambridge, Massachusetts.
Robert R. Shannon	Director and Member of Audit Committee. Mr. Shannon is a professor at the Optical Sciences Center of the University of Arizona in Tucson, Arizona.

PART II

ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

The Company's common stock is listed on the National Association of Securities Dealers Automated Quotation (NASDAQ) System under the symbol "POCI." Since January 1992, the NASDAQ SmallCap Market has been the principal market in which the Company's stock is publicly traded. The high and low sales prices for the Company's stock for each full quarterly period within the two most recent fiscal years were as follows:



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Quarter	2001 ----		2002 ----	
	High	Low	High	Low
First	\$20.25	\$7.50	\$1.99	\$.61
Second	\$8.56	\$1.81	\$ .99	\$.68
Third	\$5.59	\$1.63	\$ .98	\$.50
Fourth	\$2.55	\$1.22	\$ .73	\$.38

As of August 31, 2002, there were approximately 90 holders of record of the Company's common stock.

The Company has not declared any dividends during the last two fiscal years. At present, the Company intends to retain its earnings, if any, to finance research and development and expansion of its business.

### ITEM 6. 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, 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 regain and 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; performance of 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; which are described further in Exhibit 99.1 hereto. 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

9

which may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

#### CRITICAL ACCOUNTING POLICIES AND ESTIMATES

#### GENERAL

Management's discussion and analysis of financial condition and results

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of operations are based upon the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP"). The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

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

### REVENUE RECOGNITION

The Company recognizes revenue in accordance with U.S. GAAP and SEC Staff Accounting Bulletin ("SAB") No. 101, REVENUE RECOGNITION IN FINANCIAL STATEMENTS. SAB No. 101 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services rendered; (3) the price to the buyer is fixed and determinable; and (4) collectibility is reasonably assured. Determination of criteria (3) and (4) are based on management's judgments regarding the fixed nature of the price to the buyer charged for products delivered or services rendered and collectibility of the sales price. The Company assesses credit worthiness of customers based upon prior history with the customer and assessment of financial condition. The Company's shipping terms are customarily FOB shipping point.

### BAD DEBT

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

### INVENTORIES

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

### IMPAIRMENT OF LONG-LIVED ASSETS AND LONG-LIVED ASSETS TO BE DISPOSED OF

The Company accounts for impairment of long-lived assets in accordance with SFAS No. 121, ACCOUNTING FOR THE IMPAIRMENT OF LONG-LIVED ASSETS AND FOR LONG-LIVED ASSETS TO BE DISPOSED OF. 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

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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 through sale are reported at the lower of the carrying amount or fair value less estimated costs to sell.

### FISCAL YEAR 2002 RESULTS OF OPERATIONS

Total revenues for fiscal year 2002 decreased by approximately \$2,474,000 or 58.2% from fiscal year 2001.

The revenue decrease from the prior year was due to lower sales of medical products (down 51%), and lower sales of non-medical products (down 73%). Medical sales were lower due primarily to lower sales of stereo endoscopes and cameras, and non-stereo endoscopes. Non-medical sales were lower due primarily to lower sales of DWDM filters and DWDM test instrumentation.

Revenues from the Company's largest customers, as a percentage of total revenues, were as follows:

	2002	2001	2000
Customer A	23%	41%	46%
Customer B	18	7	11
Customer C	6	18	4
All Others	53	34	39
	----	----	----
	100%	100%	100%
	=====	=====	=====

No other customer accounted for more than 10% of the Company's revenues in fiscal years 2002, 2001, and 2000.

Gross profit for fiscal year 2002 was negative and reflected an unfavorable change of approximately \$2,158,000 compared to fiscal year 2001. Gross profit as a percentage of revenues decreased from 19.0% in fiscal year 2001 to a negative 76.0% in the current year. The unfavorable change in gross profit was due primarily to (1) a provision for excess and obsolete inventories of DWDM filters and DWDM filter test instrumentation of approximately \$540,000 recorded in the first quarter ended September 30, 2001; and (2) the reduction in sales of higher margin stereo endoscopes and related products and the lower overall sales volume of other products; and (3) a manufacturing cost structure that was not reflective of the sharply lower sales volume in fiscal year 2002. The Company has implemented significant cost reduction measures during fiscal year 2002 to address this issue, the full year effects of which will be reflected in the Company's fiscal year 2003 financial statements. See Note 6 of Notes to Consolidated Financial Statements.

Research and development expenses decreased by approximately \$944,000, or 29.4%, during fiscal year 2002 compared to the previous year. The decrease was due to a lower level of resources being devoted to the development of DWDM filters used in telecommunications systems, as reflected in reductions of staff.

Selling, general and administrative expenses decreased by approximately \$24,000, or 1.1%, during fiscal year 2002 compared to the previous year. The decrease was due primarily to lower provision for estimated uncollectable customer accounts and employee recruiting, partially offset by higher sales and marketing expense.

The sharp reduction in demand and industry-wide excess inventory levels of passive telecommunications components has hampered the Company's ability to obtain new orders for its DWDM products. In calendar year 2001, the Company announced that two major customers for DWDM filters had canceled the balance of orders placed with the Company. Revenues from DWDM filters and test instrumentation in the quarters ended September 30, 2001 and December 31, 2001 were sharply lower than in previous quarters, and such revenues were negligible in the quarters ended March 31, 2002 and June 30, 2002. Current business prospects in this marketplace continue to remain negligible because of the lack of visibility concerning future spending levels for telecommunications equipment. The provision for asset impairment and restructuring of \$4,445,021 in the year ended June 30, 2002, consists of (1) a provision for restructuring costs of \$402,065, representing the present value of future lease payments related to idle space in the Company's Optical Thin Films Technology Center, and employee severance costs; and (2) a provision for asset impairment of \$4,042,956, representing a writedown to the lower of carrying value or fair market value less estimated selling costs of certain of the Company's property and equipment invested in its optical thin films coating product line, and the writeoff of certain patent costs. These provisions are more fully described in Note 6 of Notes to Consolidated Financial Statements.

The following table sets forth the quarterly impacts and cash payments associated with the asset impairment and restructuring provisions:

Quarter Ended--	PROVISION FOR -				TOTAL
	PROPERTY & EQUIPMENT WRITEDOWN	PATENT WRITEDOWN	EMPLOYEE SEVERANCE	IDLE LEASE SPACE	
September 30, 2001	\$ 3,444,378	\$ --	\$ --	\$ --	\$ 3,444,378
December 31, 2001	--	--	186,250	482,000	668,250
June 30, 2002	541,000	57,578	--	(266,185)	332,393
Total Provision	3,985,378	57,578	186,250	215,815	4,445,021
Non-cash Charges	(3,985,378)	(57,578)	--	--	(4,042,956)
Cash Payments	--	--	(186,250)	(47,844)	(234,094)
Provision Balance, June 30, 2002	\$ --	\$ --	\$ --	\$ 167,971	\$ 167,971

Interest expense consists of interest on capital lease obligations and imputed interest on accrued restructuring costs related to the present value of future lease payments on idle space. Interest expense increased by \$8,103, or 68.3%, over fiscal year 2001 due primarily to the imputed interest on restructuring costs.

Interest income decreased by approximately \$588,000 or 75.4% during fiscal year 2002 compared to the previous year. The decrease was due to the lower base of cash and cash equivalents and lower interest rates.

The income tax provisions in fiscal year 2002 and 2001 represent the minimum statutory state income tax liability.

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### FISCAL YEAR 2001 RESULTS OF OPERATIONS

Total revenues for fiscal year 2001 increased by approximately \$1,238,000 or 41.1% from fiscal year 2000.

12

The revenue increase from the prior year was due to higher sales of medical products (up 11%), and higher sales of non-medical products (up 225%). Medical sales were higher due primarily to higher sales of stereo endoscopes and endoscopic cameras, and non-stereo endoscopes. Non-medical sales were higher due primarily to higher sales of DWDM filters and initial sales of DWDM test instrumentation.

Gross profit decreased by approximately \$235,000 in fiscal year 2001, and as a percentage of revenue decreased from 34.7% to 19.0%, compared to the previous year. The decrease in the gross profit percentage was due primarily to higher fixed manufacturing costs resulting from increased personnel, significant capital expenditures and the commencement of operations in a new optical thin film technology facility, and lower average selling prices for DWDM filters compared to fiscal year 2000.

Research and development expenses increased by approximately \$1,521,000, or 89.8%, during fiscal year 2001 compared to the previous year. During both years, 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 \$344,000, or 19.5%, during fiscal year 2001 compared to the previous year. The increase was due primarily to higher sales and marketing headcount, employee recruiting, insurance, advertising and trade show expenses, and higher provisions for estimated uncollectable customer accounts.

Interest expense relates primarily to capital lease obligations and decreased by approximately \$12,000 or 51.2% during fiscal year 2001 due to the lower average debt balance.

Interest income increased by approximately \$500,000 or 178.7% during fiscal year 2001 compared to the previous year. The increase was 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.

The income tax provision in fiscal year 2001 represents the minimum statutory state income tax liability.

### LIQUIDITY AND CAPITAL RESOURCES

For the year ended June 30, 2002, the Company's cash and cash equivalents decreased by approximately \$4,705,000 to \$5,826,000. The decrease in cash and cash equivalents was due to cash used by operating activities of approximately \$4,513,000, capital expenditures of approximately \$91,000, repayment of capital lease obligation and other of approximately \$44,000, and expenditures for other assets (primarily patents) of \$57,000.

The Company has entered into an agreement to terminate the lease on its 37,000 sq. ft. Optical Thin Film Technology Center effective September 30, 2002.

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Operations in this facility ceased in November 2001 in connection with the Company's restructuring and cost reduction measures, as previously announced. The termination agreement requires payment of a cancellation fee of approximately \$161,000, and relieves the Company of a lease obligation estimated at approximately \$460,000.

13

Contractual cash commitments for the fiscal years subsequent to June 30, 2002 are summarized as follows:

	2003	2004	THEREAFTER	TOTAL
Long-term debt	\$ --	\$ --	\$ --	\$ --
Capital leases	34,450	3,874	--	38,324
Operating leases	211,000	12,000	--	223,000
	-----	-----	-----	-----
	\$245,450	\$15,874	\$ --	\$261,324
	=====	=====	=====	=====

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

The Company believes that its cash and cash equivalents are sufficient to support working capital and investment needs for at least the next twelve months.

### RECENT ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards ("SFAS") No. 141, BUSINESS COMBINATIONS. SFAS No. 141 requires all business combinations initiated after June 30, 2001 to be accounted for using the purchase method. This statement is effective for all combinations initiated after June 30, 2001. The adoption of SFAS No. 141 on July 1, 2001 had no impact on the Company's consolidated financial statements.

In June 2001, the FASB issued SFAS No. 142, GOODWILL AND OTHER INTANGIBLE ASSETS. This statement applies to goodwill and intangible assets acquired after June 30, 2001, as well as goodwill and intangible assets previously acquired. Under this statement goodwill as well as certain other intangible assets, determined to have an indefinite life, will no longer be amortized; instead these assets will be reviewed for impairment on a periodic basis. This statement was adopted by the Company on July 1, 2001. The adoption of this new accounting standard did not have a material impact on the Company's consolidated financial statements.

In October 2001, the FASB issued SFAS No. 144, ACCOUNTING FOR THE IMPAIRMENT OR DISPOSAL OF LONG-LIVED ASSETS, which is effective in fiscal years beginning after December 15, 2001 and interim periods within those fiscal periods. SFAS No. 144 supersedes FASB Statement No. 121 ACCOUNTING FOR THE IMPAIRMENT OR DISPOSAL OF LONG-LIVED ASSETS AND FOR LONG-LIVED ASSETS TO BE DISPOSED OF, and parts of APB Opinion No. 30, REPORTING THE RESULTS OF

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OPERATIONS-REPORTING THE EFFECTS OF DISPOSAL OF A SEGMENT OF A BUSINESS, AND EXTRAORDINARY, UNUSUAL AND INFREQUENTLY OCCURRING EVENTS AND TRANSACTIONS RELATING TO EXTRAORDINARY ITEMS," however, SFAS No. 144 retains the requirement of APB Opinion No. 30 to report discontinued operations separately from continuing operations and extends that reporting to a component of an entity that either has been disposed of (by sale, by abandonment, or in a distribution to owners) or is classified as held for sale. SFAS No. 144 addresses financial accounting and reporting for the impairment of certain long-lived assets and for long-lived assets to be disposed of. The Company does not believe adopting SFAS No. 144 on July 1, 2002 will have a material impact on the Company's consolidated financial statements.

The FASB issued SFAS No. 145, RESCISSION OF FASB STATEMENTS NO. 4, 44, AND 64, AMENDMENT OF FASB STATEMENT NO. 13, AND TECHNICAL CORRECTIONS, effective for fiscal years beginning May 15, 2002 or later

14

that rescinds FASB Statement No. 4, REPORTING GAINS AND LOSSES FROM EXTINGUISHMENT OF DEBT, FASB Statement No. 64, EXTINGUISHMENTS OF DEBT MADE TO SATISFY SINKING-FUND REQUIREMENTS, and FASB Statement No. 44, ACCOUNTING FOR INTANGIBLE ASSETS OF MOTOR CARRIERS. This Statement amends SFAS No. 4 and SFAS No. 13, ACCOUNTING FOR LEASES, to eliminate an inconsistency between the required accounting for sale-leaseback transactions. This Statement also amends other existing authoritative pronouncements to make various technical corrections, clarify meanings, or describe their applicability under changed conditions. The Company does not believe adopting SFAS No. 145 on July 1, 2002 will have a material impact on its consolidated financial statements.

In July 2002, the FASB issued SFAS No. 146, ACCOUNTING FOR COSTS ASSOCIATED WITH EXIT OR DISPOSAL ACTIVITIES. SFAS No. 146 is based on the fundamental principle that a liability for a cost associated with an exit or disposal activity should be recorded when it (1) is incurred, that is, when it meets the definition of a liability in FASB Concepts Statement No. 6, ELEMENTS OF FINANCIAL STATEMENTS, and (2) can be measured at fair value. The principal reason for issuing SFAS No. 146 is the Board's belief that some liabilities for costs associated with exit or disposal activities that entities record under current accounting pronouncements, in particular EITF Issue 94-3, do not meet the definition of a liability. SFAS No. 146 nullifies EITF Issue 94-3; thus, it will have a significant effect on practice because commitment to an exit or disposal plan no longer will be a sufficient basis for recording a liability for costs related to those activities. SFAS No. 146 is effective for exit and disposal activities initiated after December 31, 2002. Early application is encouraged; however, previously issued financial statements may not be restated. An entity would continue to apply the provisions of EITF Issue 94-3 to an exit activity that is initiated under an exit plan that met the criteria of EITF Issue 94-3 before the entity initially applied SFAS No. 146. The Company does not believe adopting SFAS No. 146 on July 1, 2002 will have a material impact on its consolidated financial statements.

### TRENDS AND UNCERTAINTIES THAT MAY AFFECT FUTURE RESULTS

The Company's asset impairment, restructuring and workforce reduction measures implemented in fiscal year 2002, and other cost saving measures, are expected to result in a reduction in future annual operating expenses, primarily in the areas of cost of goods sold and research and development. These cost reduction measures are expected to result in expense savings of at least \$4 million per year, of which approximately \$3.2 million per year represent actual cash savings, and the remainder is due to a reduction in annual depreciation and amortization expense.

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For the quarter ended June 30, 2002, cash and cash equivalents decreased by approximately \$905,000, a 10% sequential decrease in cash usage from the previous quarter ended March 31, 2002. A further reduction in the rate of cash usage is anticipated during the quarter ending September 30, 2002.

Capital equipment expenditures during the year ended June 30, 2002 were approximately \$91,000, down 97% from the \$3.6 million for fiscal year 2001. Future capital equipment expenditures will be dependent upon future sales and success of on-going research and development efforts. It is anticipated that the level of capital spending for the foreseeable future will continue to be substantially lower than fiscal year 2001.

For the quarter ended June 30, 2002, research and development expenses were approximately \$355,000, down 64% from the \$999,000 for the quarter ended June 30, 2001. It is anticipated that the quarterly level of R&D expenses for the foreseeable future will be substantially lower than fiscal year 2001, but is ultimately dependent upon the Company's assessment of new product opportunities.

The Company is pursuing advances on several fronts in the medical area and certain non-medical applications of its optical technology. Among these initiatives are a new 30 degree line of sight version of the successful 5 mm laparoscope, a new version of the 4 mm arthroscope for use in carpal tunnel surgery, and other new products.

15

Following customer evaluations of a new, longer version of the Company's standard 10 mm laparoscope, a pilot production order was received for this instrument for use in bariatric surgery. The Company also previously announced several major successes related to its medical instrument business:

- The first production shipment of autoclavable endoscopes in March 2002.
- Receipt of new orders for stereo endoscopes and related products.
- Receipt of new orders for the development and production of a relay lens system for use in medical digital photo microscopy.

These initiatives have generated orders from new and existing customers totaling approximately \$780,000, of which approximately \$68,000 was shipped in fiscal year 2002, and approximately \$445,000 is scheduled to be shipped during the first half of fiscal year 2003. The timing of the remaining shipments on these orders of approximately \$267,000 is dependent upon customer delivery instructions. The Company anticipates additional follow-on orders for these products.

Achievements of ISO 9001 and CE Mark certification, as previously announced, are also expected to support increased future sales opportunities, both foreign and domestic, for the Company's medical products.

### COMMON STOCK LISTING ON NASDAQ SMALLCAP MARKET

The Company has been notified that it is not in compliance with the \$1.00 minimum share price requirement for continued listing on the Nasdaq SmallCap Market. The Company will have until February 10, 2003 to regain compliance with Nasdaq's \$1.00 minimum bid price requirement. In order to regain compliance, the bid price of the Company's common stock must close at or above \$1.00 per share for a minimum of 10 consecutive trading days. As indicated above, the Company has undertaken a number of product development and marketing initiatives to increase sales and shareholder value.

The delisting of the Company's common stock from the Nasdaq SmallCap



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Market may materially impair the stockholder's ability to buy and sell shares of the Company's common stock, and could have an adverse effect on the market price of, and the efficiency of the trading market for, the Company's common stock. In addition, the delisting of the Company's common stock could significantly impair the Company's ability to raise capital should it desire to do so in the future.

The Company's listing on the Nasdaq SmallCap Market is very important to the Company and the Company intends to take all reasonable measures to regain and maintain compliance. The Company intends to seek shareholder approval at the annual meeting of shareholders in November 2002 of an amendment to its Articles of Organization to effect a reverse stock split. The Company believes that a reverse stock split will increase the chances that its common stock will trade at or above the required \$1.00 minimum bid price. There can be no assurance, however, that a reverse stock split will have the desired consequences. Specifically, there can be no assurance that, after a reverse stock split, the market price of the common stock will not decrease to a level that causes the Company to again face de-listing, or that the Company's market capitalization after the reverse split will not be less than its market capitalization before the reverse split.

ITEM 7. CONSOLIDATED FINANCIAL STATEMENTS: The Consolidated Financial Statements are filed on pages 17 through 38 of this Form 10-KSB.

16

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

Consolidated Financial Statements  
as of June 30, 2002 and 2001  
Together with Auditors' Report

17

### REPORT OF INDEPENDENT AUDITORS

The Board of Directors and Shareholders  
Precision Optics Corporation, Inc.:

We have audited the accompanying consolidated balance sheet of Precision Optics Corporation, Inc. and subsidiaries as of June 30, 2002 and the related consolidated statements of operations, stockholders' equity and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit. The accompanying consolidated balance sheet of Precision Optics Corporation, Inc. and subsidiaries as of June 30, 2001 and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the years in the two-year period ended June 30, 2001 were audited by other auditors who have ceased operations. Those auditors expressed an unqualified opinion on those consolidated financial statements in their report dated July 24, 2001.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a

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test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 2002 consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Precision Optics Corporation, Inc. and subsidiaries as of June 30, 2002 and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

/s/ KPMG LLP

Boston, Massachusetts  
August 14, 2002

18

THE FOLLOWING REPORT OF ARTHUR ANDERSEN LLP ("ANDERSEN") IS A COPY OF THE REPORT PREVIOUSLY ISSUED BY ANDERSEN ON JULY 24, 2001. THE REPORT OF ANDERSEN IS INCLUDED IN THIS ANNUAL REPORT ON FORM 10-KSB PURSUANT TO RULE 2-02(E) OF REGULATION S-X. AFTER REASONABLE EFFORTS THE COMPANY HAS NOT BEEN ABLE TO OBTAIN A REISSUED REPORT FROM ANDERSEN. ANDERSEN HAS NOT CONSENTED TO THE INCLUSION OF ITS REPORT IN THIS ANNUAL REPORT ON FORM 10-KSB. BECAUSE ANDERSEN HAS NOT CONSENTED TO THE INCLUSION OF ITS REPORT IN THIS ANNUAL REPORT, IT MAY BE DIFFICULT FOR YOU TO SEEK REMEDIES AGAINST ANDERSEN AND YOUR ABILITY TO SEEK RELIEF AGAINST ANDERSEN MAY BE IMPAIRED.

### REPORT OF INDEPENDENT AUDITORS

To Precision Optics Corporation, Inc.:

We have audited the accompanying consolidated balance sheets of Precision Optics Corporation, Inc. (a Massachusetts corporation) and subsidiaries as of June 30, 2001 and 2000 and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended June 30, 2001. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Precision Optics Corporation, Inc. and subsidiaries as of June 30, 2001 and 2000 and the results of their operations and their cash flows for each of the three years in the period ended June 30, 2001, in conformity with accounting principles generally accepted in the United States.

/s/ Arthur Andersen, LLP



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Customer advances	30,000	--
Accrued payroll	63,650	103,392
Accrued bonuses	30,000	15,000
Accrued professional services	105,995	69,051
Accrued vacation	121,042	119,143
Accrued warranty expense	50,000	50,000
Accrued income taxes	912	912
Other accrued liabilities	24,509	68,077
Accrued restructuring expense	167,971	--
	-----	-----
Total current liabilities	746,524	1,062,056
	-----	-----
Capital Lease Obligation, net of current portion, and Other	17,705	68,703
	-----	-----
Commitments (Note 3)		
Stockholders' Equity:		
Common stock, \$0.01 par value-		
Authorized--20,000,000 shares		
Issued and outstanding--10,503,908 shares at June 30, 2002 and 2001	105,039	105,039
Additional paid-in capital	27,682,657	27,682,657
Accumulated deficit	(19,671,886)	(9,698,444)
	-----	-----
Total stockholders' equity	8,115,810	18,089,252
	-----	-----
	\$ 8,880,039	\$ 19,220,011
	=====	=====

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONSOLIDATED FINANCIAL STATEMENTS.

20

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Operations  
for the Years Ended June 30, 2002, 2001, and 2000

	2002	2001
Revenues	\$ 1,774,283	\$ 4,247,828
Cost of Goods Sold	3,123,196	3,438,679
	-----	-----
Gross profit (loss)	(1,348,913)	809,149
	-----	-----
Research and Development Expenses	2,270,880	3,215,257
Selling, General and Administrative Expenses	2,079,994	2,103,517
Provision for Asset Impairment and Restructuring	4,445,021	--
	-----	-----
Total operating expenses	8,795,895	5,318,774
	-----	-----

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Operating loss	(10,144,808)	(4,509,625)
Interest Income	192,241	780,395
Interest Expense	(19,963)	(11,860)
Loss before provision for income taxes	(9,972,530)	(3,741,090)
Provision for Income Taxes	912	912
Net loss	\$ (9,973,442)	\$ (3,742,002)
Basic and Diluted Loss per Share	\$ (.95)	\$ (.36)
Weighted Average Common Shares Outstanding	10,503,908	10,473,348

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONSOLIDATED FINANCIAL STATEMENTS.

21

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Stockholders' Equity  
for the Years Ended June 30, 2002, 2001 and 2000

	Number of Shares	Common Stock	Additional Paid-in Capital	Ac
Balance, June 30, 1999	6,687,595	\$ 66,876	\$ 6,206,411	\$
Proceeds from exercise of options and warrants to purchase common stock	1,808,100	18,081	3,908,836	
Net proceeds from private placement of common stock	1,789,463	17,895	14,978,948	
Net loss	--	--	--	
Balance, June 30, 2000	10,285,158	102,852	25,094,195	
Proceeds from litigation settlement	--	--	2,368,485	
Proceeds from exercise of options and warrants to purchase common stock	218,750	2,187	236,898	
Costs associated with private placement of common stock	--	--	(16,921)	
Net loss	--	--	--	

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Balance, June 30, 2001	10,503,908	105,039	27,682,657	
Net loss	--	--	--	--
Balance, June 30, 2002	<u>\$10,503,908</u>	<u>\$105,039</u>	<u>\$ 27,682,657</u>	<u>\$ (</u>

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONSOLIDATED FINANCIAL STATEMENTS.

22

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows for the Years Ended June 30, 2002, 2001, and 2000

	2002	2001
<b>Cash Flows from Operating Activities:</b>		
Net loss	\$ (9,973,442)	\$ (3,7
Adjustments to reconcile net loss to net cash used in operating activities-		
Depreciation and amortization	593,491	7
Provision for asset impairment	4,042,956	
Provision for inventory write-down	540,000	
Other	(25,345)	
Changes in operating assets and liabilities-		
Accounts receivable, net	628,997	(3
Inventories	(24,890)	(4
Prepaid expenses	16,186	(
Refundable income taxes	(13,849)	
Accounts payable	(465,885)	2
Accrued restructuring expense	167,971	
Customer advances	30,000	
Other accrued expenses	(29,467)	
Net cash used in operating activities	<u>(4,513,277)</u>	<u>(3,4</u>
<b>Cash Flows from Investing Activities:</b>		
Purchases of property and equipment	(90,818)	(3,6
Increase in other assets	(56,798)	(
Net cash used in investing activities	<u>(147,616)</u>	<u>(3,6</u>
<b>Cash Flows from Financing Activities:</b>		
Repayment of capital lease obligation and other	(43,804)	(
Proceeds from litigation settlement	--	2,3
Net proceeds (costs) from private placements of common stock	--	(
Proceeds from exercise of stock options and warrants	--	2
Net cash provided by (used in) financing activities	<u>(43,804)</u>	<u>2,4</u>
Net Increase (Decrease) in Cash and Cash Equivalents	<u>(4,704,697)</u>	<u>(4,5</u>
Cash and Cash Equivalents, beginning of year	\$ 10,530,298	15,1
Cash and Cash Equivalents, end of year	\$ 5,825,601	\$ 10,5

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Supplemental Disclosure of Cash Flow Information:	=====	=====
Cash paid during the year for-		
Interest	\$ 19,963	\$
	=====	=====
Income taxes	\$ 912	\$
	=====	=====
Supplemental Disclosure of Noncash Investing and Financing Activities:		
Capital lease obligation	\$ --	\$
	=====	=====

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONSOLIDATED FINANCIAL STATEMENTS.

23

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements, June 30, 2002

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) NATURE OF BUSINESS

Precision Optics Corporation, Inc. (the "Company") designs, develops, manufactures and sells specialized optical systems and components and optical thin-film coatings. The Company conducts business in one industry segment only and its customers are primarily domestic. The Company's products and services fall into two principal areas: (i) medical products for use by hospitals and physicians and (ii) advanced optical system design and development services and products.

The Company has incurred significant operating losses during the last six fiscal years. This trend was primarily the result of the loss of several significant customers, completion of several large nonrecurring government contracts, and operating losses and provision for asset impairment, restructuring, and inventory write-downs associated with the downturn in demand for optical filters used in telecommunications systems. In fiscal 1998, the Company began making significant investments in research and development and capital purchases for new products. In August 1999 and March 2000, the Company raised gross proceeds of approximately \$16 million of additional cash through the issuance of common stock (see Note 4). The Company believes, based on its operating and strategic plans along with the cash generated from the fiscal year 2000 equity financings, that it will have sufficient funds to conduct operations through at least the next fiscal year.

(b) PRINCIPLES OF CONSOLIDATION

The accompanying consolidated financial statements include the accounts of the Company and its two wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

(c) REVENUES

In December 1999, the Securities and Exchange Commission issued Staff

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Accounting Bulletin ("SAB") No. 101 which establishes guidance in applying generally accepted accounting principles to revenue recognition in financial statements and was effective for the Company's fiscal year 2001. SAB No. 101 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services rendered; (3) the price to the buyer is fixed and determinable; and (4) collectibility is reasonably assured. The Company's shipping terms are customarily FOB shipping point. The Company's revenue recognition practices comply with the guidance in the bulletin.

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. Contract revenues 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. When the estimate on a contract indicates a loss, the Company's policy is to record the entire estimated loss in the current period.

24

### PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

#### Notes to Consolidated Financial Statements June 30, 2002

##### (d) CASH AND CASH EQUIVALENTS

The Company includes in cash equivalents all highly liquid investments with original maturities of three months or less at the time of acquisition. Cash equivalents of \$5,678,705 and \$9,951,016 at June 30, 2002 and 2001, respectively, consist primarily of overnight repurchase agreements, money market funds, and United States Treasury bills.

##### (e) INVENTORIES

Inventories are stated at the lower of cost (first-in, first-out) or market and include material, labor and manufacturing overhead. The components of inventories at June 30, 2002 and 2001 are as follows:

	2002	2001
Raw material	\$ 532,228	\$ 777,269
Work-in-progress	302,128	462,517
Finished goods	174,653	284,333
	-----	-----
	\$ 1,009,009	\$ 1,524,119
	=====	=====

##### (f) PROPERTY AND EQUIPMENT

Property and equipment are recorded at cost. Maintenance and repair items are expensed as incurred. The Company provides for depreciation and amortization by charges to operations, using the straight-line and declining-balance methods, which allocate the cost of property and



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equipment over the following estimated useful lives:

ASSET CLASSIFICATION	ESTIMATED USEFUL LIFE
Machinery and equipment	3-7 years
Leasehold improvements	Shorter of lease term or estimated useful life
Furniture and fixtures	5 years
Vehicles	3 years

Amortization of assets under capital leases is included in depreciation and amortization expense. Depreciation and amortization expense was \$552,116, \$698,488 and \$432,867 for the years ended June 30, 2002, 2001 and 2000, respectively.

### (g) SIGNIFICANT CUSTOMERS AND CONCENTRATION OF CREDIT RISK

Statement of Financial Accounting Standards (SFAS) No. 105, DISCLOSURE OF INFORMATION ABOUT FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK AND FINANCIAL INSTRUMENTS WITH CONCENTRATIONS OF CREDIT RISK, requires disclosure of any significant off-balance sheet and credit risk concentrations. Financial instruments that subject the Company to credit risk consist primarily of

25

## PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements June 30, 2002

cash and cash equivalents and trade accounts receivable. The Company places its investments in highly rated financial institutions. The Company has not experienced any losses on these investments to date. At June 30, 2002 and 2001, receivables from the Company's largest customer were approximately 63% and 59% of the total accounts receivable, respectively. No other customer accounted for more than 10% of the Company's receivables as of June 30, 2002 and 2001. The Company has not experienced any material losses related to accounts receivable from individual customers. The Company generally does not require collateral or other security as a condition of sale rather relying on credit approval, balance limitation and monitoring procedures to control credit risk of trade account financial instruments. Management believes that allowances for doubtful accounts, which are established based upon review of specific account balances and historical experience, are adequate.

Revenues from the Company's largest customers, as a percentage of total revenues, were as follows:

	2002	2001	2000
Customer A	23%	41%	46%
Customer B	18	7	11
Customer C	6	18	4
All Others	53	34	39
	---	---	---

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100%	100%	100%
====	====	====

No other customer accounted for more than 10% of the Company's revenues in fiscal year 2002, 2001 and 2000.

### (h) LOSS PER SHARE

The Company calculates earnings per share according to SFAS No. 128, EARNINGS 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 each of the three years in the period ended June 30, 2002, the effect of stock options and warrants was antidilutive; therefore, they were not included in the computation of diluted loss per share. The number of shares that were excluded from the computation, as their effect would be antidilutive, were 1,209,198, 1,232,598 and 1,396,698 during fiscal 2002, 2001, and 2000, respectively.

### (i) STOCK-BASED COMPENSATION

The Company accounts for its stock-based compensation using the intrinsic value method provided for under Accounting Principles Board Opinion No. 25, ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES and related interpretations, including FASB Interpretation No. 44, ACCOUNTING FOR CERTAIN TRANSACTIONS INVOLVING STOCK COMPENSATION, AN INTERPRETATION OF APB OPINION NO. 25, issued in March 2000. 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. 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 earnings and earnings per share as if the fair value accounting prescribed by SFAS No. 123 had been adopted, as well as certain other information. [See Note 4 (c)].

26

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements June 30, 2002

### (j) FOREIGN CURRENCY TRANSLATION

The Company translates certain accounts and financial statements of its foreign subsidiary in accordance with SFAS No. 52, FOREIGN CURRENCY TRANSLATION. The functional currency of the Company's foreign subsidiary is the United States dollar. Accordingly, translation gains or losses are reflected in the accompanying consolidated statements of operations and have not been significant.

### (k) PATENTS

Patents are carried at cost, less accumulated amortization of approximately \$253,000 and \$232,000 at June 30, 2002 and 2001, respectively. Such costs are amortized using the straight-line method over the shorter of their legal or estimated useful lives, generally

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five to ten years. Amortization expense was \$41,375, \$32,012, and \$48,702 for the years ended June 30, 2002, 2001, and 2000, respectively.

### (l) FINANCIAL INSTRUMENTS

SFAS No. 107, DISCLOSURE ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS, requires disclosures about the fair value of financial instruments. Financial instruments consist principally of cash equivalents, accounts receivable, accounts payable, and accrued expenses. The estimated fair value of these financial instruments approximates their carrying value due to the short-term nature of these financial instruments.

### (m) LONG-LIVED ASSETS

The Company accounts for long-lived assets in accordance with SFAS No. 121, ACCOUNTING FOR THE IMPAIRMENT OF LONG-LIVED ASSETS AND FOR LONG-LIVED ASSETS TO BE DISPOSED OF. 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 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 costs to sell.

### (n) WARRANTY COSTS

The Company does not incur future performance obligations in the normal course of business other than providing 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 were \$9,317, \$26,219, and \$11,221 for the years ended June 30, 2002, 2001, and 2000, respectively and have been included as a component of cost of goods sold in the accompanying consolidated statements of operations.

27

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements June 30, 2002

### (o) RESEARCH AND DEVELOPMENT

Research and development expenses are charged to operations as incurred.

### (p) COMPREHENSIVE INCOME

SFAS No. 130 requires disclosure of all components of comprehensive income on an annual and interim basis. Comprehensive income is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowners sources.

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The Company's comprehensive loss for the years ended June 30, 2002, 2001 and 2000 was equal to its net loss for the same periods.

### (q) INCOME TAXES

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases 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.

### (r) USE OF ESTIMATES

The preparation of financial statements in conformity with accounting standards generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

### (s) RECENT ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards ("SFAS") No. 141, BUSINESS COMBINATIONS. SFAS No. 141 requires all business combinations initiated after June 30, 2001 to be accounted for using the purchase method. This statement is effective for all combinations initiated after June 30, 2001. The adoption of SFAS No. 141 on July 1, 2001 had no impact on the Company's consolidated financial statements.

In June 2001, the FASB issued SFAS No. 142, GOODWILL AND OTHER INTANGIBLE ASSETS. This statement applies to goodwill and intangible assets acquired after June 30, 2001, as well as goodwill and intangible assets previously acquired. Under this statement goodwill as well as certain other intangible assets, determined to have an indefinite life, will no longer be amortized; instead these assets will be reviewed for impairment on a periodic basis. This statement was adopted by the Company on July 1, 2001. The adoption of this new accounting standard did not have a material impact on the Company's consolidated financial statements.

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fiscal years beginning after December 15, 2001 and interim periods within those fiscal periods. SFAS No. 144 supersedes FASB Statement No. 121 ACCOUNTING FOR THE IMPAIRMENT OR DISPOSAL OF LONG-LIVED ASSETS AND FOR LONG-LIVED ASSETS TO BE DISPOSED OF, and parts of APB Opinion No. 30, REPORTING THE RESULTS OF OPERATIONS—REPORTING THE EFFECTS OF DISPOSAL OF A SEGMENT OF A BUSINESS, AND EXTRAORDINARY, UNUSUAL AND INFREQUENTLY OCCURRING EVENTS AND TRANSACTIONS RELATING TO EXTRAORDINARY ITEMS, however, SFAS No. 144 retains the requirement of APB Opinion No. 30 to report discontinued operations separately from continuing operations and extends that reporting to a component of an entity that either has been disposed of (by sale, by abandonment, or in a distribution to owners) or is classified as held for sale. SFAS No. 144 addresses financial accounting and reporting for the impairment of certain long-lived assets and for long-lived assets to be disposed of. The Company does not believe adopting SFAS No. 144 on July 1, 2002 will have a material impact on the Company's consolidated financial statements.

The FASB issued SFAS No. 145, RESCISSION OF FASB STATEMENTS NO. 4, 44, AND 64, AMENDMENT OF FASB STATEMENT NO. 13, AND TECHNICAL CORRECTIONS, effective for fiscal years beginning May 15, 2002 or later that rescinds FASB Statement No. 4, REPORTING GAINS AND LOSSES FROM EXTINGUISHMENT OF DEBT, FASB Statement No. 64, EXTINGUISHMENTS OF DEBT MADE TO SATISFY SINKING-FUND REQUIREMENTS, and FASB Statement No. 44, ACCOUNTING FOR INTANGIBLE ASSETS OF MOTOR CARRIERS. This Statement amends SFAS No. 4 and SFAS No. 13, ACCOUNTING FOR LEASES, to eliminate an inconsistency between the required accounting for sale-leaseback transactions. This Statement also amends other existing authoritative pronouncements to make various technical corrections, clarify meanings, or describe their applicability under changed conditions. The Company does not believe adopting SFAS No. 145 on July 1, 2002 will have a material impact on its consolidated financial statements.

In July 2002, the FASB issued SFAS No. 146, ACCOUNTING FOR COSTS ASSOCIATED WITH EXIT OR DISPOSAL ACTIVITIES. SFAS No. 146 is based on the fundamental principle that a liability for a cost associated with an exit or disposal activity should be recorded when it (1) is incurred, that is, when it meets the definition of a liability in FASB Concepts Statement No. 6, ELEMENTS OF FINANCIAL STATEMENTS, and (2) can be measured at fair value. The principal reason for issuing SFAS No. 146 is the Board's belief that some liabilities for costs associated with exit or disposal activities that entities record under current accounting pronouncements, in particular EITF Issue 94-3, do not meet the definition of a liability. SFAS No. 146 nullifies EITF Issue 94-3; thus, it will have a significant effect on practice because commitment to an exit or disposal plan no longer will be a sufficient basis for recording a liability for costs related to those activities. SFAS No. 146 is effective for exit and disposal activities initiated after December 31, 2002. Early application is encouraged; however, previously issued financial statements may not be restated. An entity would continue to apply the provisions of EITF Issue 94-3 to an exit activity that is initiated under an exit plan that met the criteria of EITF Issue 94-3 before the entity initially applied SFAS No. 146. The Company does not believe adopting SFAS No. 146 on July 1, 2002 will have a material impact on its consolidated financial statements.

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### (2) CAPITAL LEASE OBLIGATION

At June 30, 2002, future minimum lease payments under capital lease obligation are as follows:

	AMOUNT
Fiscal year ended June 30 -	
2003	\$34,450
2004	3,874
	-----
Total minimum lease payments	38,324
Amount representing interest (at rates ranging from 7.5% to 9.4%)	1,721
	-----
Present value of future minimum lease payments	36,603
Less--Current portion	33,544
	-----
	\$ 3,059
	=====

Capital leases are secured by substantially all assets of the Company under a security agreement.

### (3) COMMITMENTS

#### (a) RELATED PARTY TRANSACTIONS

The Company leases one of its facilities from a corporation owned by an officer of the Company. The lease terminated in December 1999 and required lease payments of \$9,000 per month. The Company is currently a tenant at will paying lease payments of \$9,000 a month. Total rent expense for related parties included in the accompanying consolidated statements of operations amounted to \$108,000 in each of fiscal years 2002, 2001, and 2000.

The Company paid fees to a director of approximately \$24,000, \$24,000, and \$45,000 for services performed during fiscal 2002, 2001 and 2000, respectively. Another director is a former partner in a law firm that has performed legal services for the Company during fiscal 2002, 2001 and 2000 of approximately \$117,000, \$320,000, and \$253,000, respectively. Another director is the owner of a company that provided approximately \$19,000, \$20,000, and \$67,000 in software and consulting services to the Company during fiscal 2002, 2001 and 2000, respectively.

#### (b) OPERATING LEASE COMMITMENTS

In August 2000, the Company entered into a facility lease for development and manufacturing purposes. The lease includes a yearly escalation clause and provides for the option to renew at the end of the term. Lease commitments began in November 2000 and include estimated-shared costs. The lease expires in October 2005. In August 2002, the Company entered into a lease termination agreement, providing for the termination of this lease effective September 30,

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2002 by payment of a lease cancellation fee of approximately \$161,000 in September 2002. [See Note 6]

30

### PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements June 30, 2002

The Company has entered into operating leases for its office space and equipment that expire at various dates through fiscal year 2004. Total future minimum rental payments under all non-cancelable operating leases are approximately as follows:

	AMOUNT
Fiscal year ended June 30--	
2003	\$ 211,000
2004	12,000
	-----
	\$ 223,000
	=====

Rent expense on operating leases was approximately \$178,000, \$258,000, and \$158,000 for the years ended June 30, 2002, 2001 and 2000, respectively.

#### (4) STOCKHOLDERS' EQUITY

##### (a) PRIVATE PLACEMENTS

In fiscal year 2000, the Company completed two private placements of a total of 1,789,463 shares of common stock with net proceeds of \$14,996,843. In conjunction with this offering, the purchasers were issued warrants to acquire 1,465,798 shares of common stock at a weighted average exercise price of \$9.26 per share.

##### (b) WARRANTS

During fiscal year 2000, warrants with an exercise price of \$4.00 per share for 500,000 common shares and warrants with an exercise price of \$1.125 per share for 789,500 common shares were exercised, resulting in proceeds to the Company of \$2,888,188. During fiscal year 2001, warrants with an exercise price of \$1.125 per share for 210,500 shares were exercised resulting in proceeds to the Company of \$236,813. As of June 30, 2002, the Company had 465,798 fully-exercisable warrants to acquire common stock outstanding at a weighted average exercise price of \$26.73. The warrants are immediately exercisable and expire in March 2005.

##### (c) STOCK OPTIONS

During fiscal 1989, the stockholders approved a stock option plan (the "1989 Plan") for key employees. The 1989 Plan, as amended, authorizes the grant of options of up to 1,110,000 shares of the Company's common stock at an exercise price of not less than 100% of the fair market value per share at the date of grant. Options granted vest and are

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exercisable for periods determined by the Board of Directors, not to exceed 10 years from the date of grant.

During fiscal 1998, the stockholders approved an incentive plan (the "1997 Incentive Plan"), which provides eligible participants (certain employees, directors, consultants, etc.) the opportunity to receive a broad variety of equity based and cash awards. Options granted vest and are exercisable for periods determined by the Board of Directors, not to exceed 10 years from the date of grant. A total of 1,200,000 shares of common stock have been reserved for issuance under the 1997 Incentive Plan. Upon the adoption of the 1997 Incentive Plan, no new awards will be granted under the 1989 Plan. At June 30, 2002, 614,750 shares of common stock were available for future grants under the 1997 Incentive Plan.

31

### PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

#### Notes to Consolidated Financial Statements June 30, 2002

The following is a summary of transactions in the plans for the three years ended June 30, 2002:

	NUMBER OF SHARES	OPTION PRICE PER SHARE	WEIGHTED AVERAGE EXERCISE PRICE
Options outstanding, June 30, 1999	961,500	1.312-3.844	2.39
Granted	215,000	1.00-5.00	3.91
Exercised	(441,100)	1.00-3.844	2.13
Canceled	(81,500)	1.00-3.844	2.55
	-----	-----	-----
Options outstanding, June 30, 2000	653,900	1.00-5.00	3.03
Granted	66,900	2.50-12.50	5.65
Exercised	(8,250)	1.00-1.563	1.36
Canceled	(750)	3.844	3.844
	-----	-----	-----
Options outstanding, June 30, 2001	711,800	\$1.00-12.50	\$ 2.73
Granted	180,500	.67-1.19	.78
Canceled	(203,900)	1.00-5.00	4.93
	-----	-----	-----
Options outstanding, June 30, 2002	688,400	\$ .67-12.50	\$ 2.33
	=====	=====	=====
Options exercisable, June 30, 2002	556,450	\$ .67-12.50	\$ 2.53
	=====	=====	=====
Options exercisable, June 30, 2001	551,125	\$1.00-12.50	\$ 2.95
	=====	=====	=====
Options exercisable, June 30, 2000	386,400	\$ 1.00-5.00	\$ 2.42
	=====	=====	=====

32

### PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES



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Notes to Consolidated Financial Statements June 30, 2002

The following table summarizes information about stock options outstanding and exercisable at June 30, 2002:

	OPTIONS OUTSTANDING			OPTIONS EXERCISABLE	
Range of Exercise Prices	Options Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Options Exercisable	Weighted Average Exercise Price
\$.67-\$ .76	152,100	9.56 years	\$.71	56,775	
1.00 - 1.375	190,900	4.29 years	\$1.31	165,225	
1.56 - 2.19	111,000	4.85 years	\$1.82	111,000	
2.75	6,250	5.12 years	\$2.75	6,250	
3.84 - 5.50	216,250	5.94 years	\$4.05	211,250	
12.50	11,900	8.17 years	\$12.50	5,950	
\$.67 - \$12.50	----- 688,400 =====	4.89 years	\$2.33	----- 556,450 =====	

In addition, the Company has granted options outside the plans, primarily to directors and consultants at 100% of the fair market value per share at the date of grant. The weighted average remaining contractual life of the options outside the plans is 2.66 years as of June 30, 2002. The following is a summary of all transactions outside the plans:

	NUMBER OF SHARES	OPTION PRICE PER SHARE	WEIGHTED AVERAGE EXERCISE PRICE
Options outstanding, June 30, 1999	144,000	0.50-5.69	
Exercised	(77,500)	0.50-5.69	
	-----	-----	
Options outstanding, June 30, 2000	66,500	0.50-1.375	
Canceled	(11,500)	0.50	
	-----	-----	
Options outstanding, June 30, 2001	55,000	\$1.30-1.375	
	=====	=====	
Options outstanding, June 30, 2002	55,000	\$1.30-1.375	
	=====	=====	
Options exercisable, June 30, 2002	55,000	\$1.30-1.375	
	=====	=====	

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Options exercisable, June 30, 2001	55,000	\$1.30-1.375
	=====	=====

33

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements June 30, 2002

The Company has computed the pro forma disclosures required under SFAS No. 123 for fiscal 2002, 2001 and 2000 using the Black-Scholes option pricing model prescribed by SFAS No. 123.

The assumptions used for each of the three years in the period ended June 30, 2002 are as follows:

	YEAR ENDED		
	2002	2001	2000
Risk-free interest rates	4.10%	5.52%	6.30%
Expected dividend yield	-	-	-
Expected lives	7 years	7 years	7 years
Expected volatility	279%	123%	99%
Weighted average fair value of grants	\$ .78	\$ 5.18	\$ 3.32

The effect of applying SFAS No. 123 would be as follows:

	YEAR ENDED		
	2002	2001	2000
Net loss-			
As reported	\$ (9,973,442)	\$ (3,742,002)	\$ (2,155,890)
Pro forma	\$ (10,071,916)	\$ (4,204,298)	\$ (2,623,201)
Net loss per share-			
As reported, basic and diluted	\$ (.95)	\$ (.36)	\$ (.26)
Pro forma, basic and diluted	\$ (.96)	\$ (.40)	\$ (.31)

(5) INCOME TAXES

The provision for income taxes in the accompanying consolidated statements of operations consists of the following for the three years ended June 30, 2002:

	2002	2001	2000
Current-			

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Federal	\$ --	\$ --	\$ --
State	912	912	912
Foreign	--	--	--
	-----	-----	-----
	912	912	912
	-----	-----	-----
Deferred-			
Federal	--	--	--
State	--	--	--
	-----	-----	-----
	\$ 912	\$ 912	\$ 912
	=====	=====	=====

34

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements June 30, 2002

A reconciliation of the federal statutory rate to the Company's effective tax rate for the three years ended June 30, 2002 is as follows:

	2002	2001	2000
Income tax benefit at federal statutory rate	(34.0)%	(34.0)%	(34.0)%
Increase (decrease) in tax resulting from-			
State taxes, net of federal benefit	(6.0)	(6.0)	(6.0)
Tax Credits	(.7)	(4.9)	(2.8)
Change in valuation allowance (net of valuation allowance of approximately \$929,000 and \$2,223,000 related to items allocable to stockholders' equity for fiscal 2001 and 2000, respectively)	40.0	44.5	38.7
Other	.7	.4	4.1
	-----	-----	-----
Effective tax rate	0.0%	0.0%	0.0%
	=====	=====	=====

35

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements June 30, 2002

The components of the net deferred tax asset at June 30, 2002 and 2001 are approximately as follows:

	2002	2001
Deferred tax assets:		

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Net operating loss carryforwards	\$ 5,553,000	\$ 3,758,000
Tax credit carryforwards	595,000	527,000
Reserves and accruals not yet deducted for tax purposes	3,972,000	1,787,000
	-----	-----
Total deferred tax assets	10,120,000	6,072,000
Deferred tax liabilities:		
Accelerated depreciation	(485,000)	(425,000)
Valuation allowance	(9,635,000)	(5,647,000)
	-----	-----
Net deferred tax asset	\$           --	\$           --
	=====	=====

The Company has provided a valuation allowance to reduce the net deferred tax asset to an amount the Company believes is "more likely than not" to be realized. The valuation allowance increased in fiscal 2002 by approximately \$3,988,000 primarily due to the generation of a net operating loss carryforward and the recording of provisions for asset impairment and restructuring. Approximately \$2,241,000 of the valuation allowance at June 30, 2002 related to the exercise of stock options will be allocated to stockholders' equity when recognized. As of June 30, 2002, the Company has net operating loss carryforwards for U.S. federal and state income taxes of approximately \$13,880,000 and \$14,339,000, respectively. The U.S. federal net operating loss carryforwards expire approximately as follows: \$730,000 in 2013, \$1,500,000 in 2019, \$7,150,000 in 2020, and \$4,500,000 in 2022. The state net operating loss carryforwards expire approximately as follows: \$1,244,000 in 2003, \$1,487,000 in 2004, \$7,108,000 in 2005, and \$4,500,000 in 2007. The tax credit carryforwards expire in 2003 through 2022. Pursuant to the Tax Reform Act of 1986, the utilization of net operating loss carryforwards for tax purposes may be subject to an annual limitation if a cumulative change of ownership of more than 50% occurs over a three-year period. As a result of the Company's recent stock offerings, such a change in ownership may have occurred. In the event that the Company has had a change in ownership, as defined, the utilization of substantially all of the Company's net operating loss carryforwards may be restricted.

### (6) PROVISION FOR ASSET IMPAIRMENT AND RESTRUCTURING

The sharp reduction in demand and industry-wide excess inventory levels of passive telecommunications components has hampered the Company's ability to obtain new orders for its DWDM products. In calendar year 2001, the Company announced that two major customers for DWDM filters had canceled the balance of orders placed with the Company.

Revenues from DWDM filters and test instrumentation in the quarters ended September 30, 2001 and December 31, 2001 were sharply lower than in previous quarters, and such revenues were negligible in the quarters ended March 31, 2002 and June 30, 2002. Current business prospects in this marketplace continue to remain negligible because of the lack of visibility concerning future spending levels for telecommunications equipment.

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Notes to Consolidated Financial Statements June 30, 2002

### Asset Impairment:

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 121: ACCOUNTING FOR THE IMPAIRMENT OF LONG-LIVED ASSETS AND FOR LONG-LIVED ASSETS TO BE DISPOSED OF, the Company reviews the recoverability of its long-lived assets when changes in circumstances indicate the carrying value of the asset may not be recoverable. As a result of the business conditions noted above, the Company determined such an assessment was required for the assets invested in its optical thin films business. The Company assesses recoverability of its assets based upon cumulative expected undiscounted cash flows of the related product lines. As a result of this assessment, the Company determined that the costs invested in certain property and equipment of the Company's optical thin film coating business are not fully recoverable and, under generally accepted accounting principles, should be written down to the lower of carrying value or fair market value (or, in the case of assets held for sale, fair value less cost to sell). Fair market value was determined by an independent appraisal based on a market approach.

Consequently, in the quarter ended September 30, 2001, the Company recorded a pretax non-cash charge of \$3,444,378 for the impairment in value of certain of its optical thin film coating property and equipment.

As a result of the continuing and more recent decline in spending levels for telecommunications equipment, the Company obtained an updated independent appraisal of the fair market value of its optical thin film coating fixed assets and reviewed the recoverability of other intangible assets, as part of its review of fiscal year 2002 financial results. This assessment resulted in an additional pretax non-cash impairment charge of \$598,578 recorded in the quarter ended June 30, 2002, which includes a charge of approximately \$58,000 for the writeoff of certain patent costs deemed not to have future value.

The thin film coating equipment used in the Company's telecommunications product line is idle, and as of June 30, 2002, is being held for sale. Accordingly, these assets (whose fair value less cost to sell is estimated at \$847,696) have been reclassified to the category of "Assets held for sale" in the accompanying consolidated balance sheet as of June 30, 2002.

### Restructuring:

On August 1, 2001, the Company announced that it had reduced its workforce by approximately 30%, or 24 employees, and indicated it would be monitoring marketplace conditions to determine whether additional cost savings measures would be necessary.

The Company has taken additional measures to reflect the lower revenue expectations in its telecommunications product line by a further reduction in its workforce in November, 2001, and by recording provisions for employee severance and costs of idle leased space in its Optical Thin Films Technology Center. The November 2001 workforce reduction affected 13 employees, or 24% of the existing workforce.

As a result of these actions, the Company recorded a non-recurring pretax charge to earnings of \$402,065 in the year ended June 30, 2002, consisting of (1) a non-cash element of \$215,815 representing the present value of future lease payments related to idle space in the Company's Optical Thin Films Technology Center plus a lease cancellation fee of approximately \$161,000, and (2) \$186,250 representing employee severance costs.

During the year ended June 30, 2002, cash payments of \$234,094 were made for

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lease payments related to idle space and employee severance costs, leaving a balance of \$167,971 of accrued restructuring expense, at June 30, 2002, related to lease payments and lease termination costs. The balance of accrued restructuring expense is expected to be paid during the quarter ending September 30, 2002.

37

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements June 30, 2002

The following table sets forth the quarterly impacts and cash payments associated with the asset impairment and restructuring provisions:

	PROVISION FOR -			
	PROPERTY & EQUIPMENT WRITEDOWN	PATENT WRITEDOWN	EMPLOYEE SEVERAMCE	IDL LEA SPA
Quarter Ended -				
September 30, 2001	\$ 3,444,378	\$ --	\$ --	\$ --
December 31, 2001	--	--	186,250	48
June 30, 2002	541,000	57,578	--	(26)
	-----	-----	-----	-----
Total Provision	3,985,378	57,578	186,250	21
Non-cash Charges	(3,985,378)	(57,578)	--	--
Cash Payments	--	--	(186,250)	(4)
	-----	-----	-----	-----
Provision Balance, June 30, 2002	\$ --	\$ --	\$ --	\$ 16
	=====	=====	=====	=====

(7) PROVISION FOR INVENTORY WRITE-DOWN

As a result of the business conditions noted above, the Company determined that certain inventories of DWDM filters and filter test instrumentation would not be sold within the Company's business cycle or the products' life cycle. Consequently, the Company recorded, in cost of goods sold, a provision for excess and obsolete inventory of approximately \$540,000 in the first quarter ended September 30, 2001.

(8) PROFIT SHARING PLAN

The Company has a defined contribution 401K profit sharing plan. Employer profit sharing and matching contributions to the plan are discretionary. No employer profit sharing contributions were made to the plan in fiscal years 2002, 2001, or 2000. Employer matching contributions to the plan amounted to \$34,608, \$32,354, and \$29,983 for fiscal years 2002, 2001 and 2000, respectively.

(9) SEGMENT REPORTING

SFAS No. 131 establishes standards for reporting information regarding operating segments in annual financial statements and requires selected information for those segments to be presented in interim financial reports issued to stockholders. SFAS No. 131 also

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establishes standards for related disclosures about products and services and geographic areas. Operating segments are identified as components of an enterprise about which separate discrete financial information is available for evaluation by the chief operating decision maker, or decision making group, in making decisions about how to allocate resources and assess performance. The Company's chief decision-maker, as defined under SFAS No. 131, is the Chief Executive Officer. To date, the Company has viewed its operations and manages its business as principally one segment. For all periods presented, over 90% of the Company's sales have been to customers in the United States.

38

ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE: As previously disclosed on a current report on Form 8-K filed with the Securities and Exchange Commission on July 2, 2002 (the "Form 8-K"), the Company dismissed Arthur Andersen LLP ("Arthur Andersen") as its independent accountants on July 1, 2002. The Company's Audit Committee and Board of Directors approved this action.

The reports of Arthur Andersen on the Company's financial statements for the two fiscal years ended June 30, 2001 and June 30, 2000 contained no adverse opinion or disclaimer of opinion and were not qualified or modified as to uncertainty, audit scope or accounting principles.

During the Company's fiscal years ended June 30, 2001 and June 30, 2000, and through July 1, 2002, there were no disagreements, resolved or unresolved, with Arthur Andersen on any matter of accounting principles or practices, financial statement disclosure or auditing scope or procedure, which disagreements, if not resolved to the satisfaction of Arthur Andersen, would have caused Arthur Andersen to make reference thereto in connection with its reports on the financial statements.

During the Company's fiscal years ended June 30, 2001 and June 30, 2000, and through July 1, 2002, Arthur Andersen has not advised the Company as to any of the matters described in Item 304(a)(1)(iv)(B) of Regulation S-B promulgated under the Securities Act of 1933, as amended.

The Company has been unable, after reasonable efforts, to have Arthur Andersen review and respond to the above disclosure; however, Arthur Andersen provided a letter dated July 2, 2002 stating that it was in agreement with the disclosure included in paragraphs 2, 3 and 4 of the Form 8-K, which disclosure is the same as the disclosure in paragraphs 2, 3 and 4 of the response to this Item 8.

On July 16, 2002, the Company engaged KPMG LLP as its new independent accountant. The Company's Audit Committee and Board of Directors approved this action. The decision to engage KPMG LLP followed the Company's evaluation of proposals from several accounting firms.

During the Company's fiscal years ended June 30, 2001 and June 30, 2000, and through July 16, 2002, neither the Company nor any person on the Company's behalf consulted with KPMG LLP regarding: (i) the application of accounting principles to a specific completed or contemplated transaction, or the type of audit opinion that might be rendered on the Company's financial statements, or (ii) any matter that was the subject of a disagreement or event described in Item 304(a)(1)(iv) of Regulation S-B.

### PART III

ITEM 9. DIRECTORS, EXECUTIVE OFFICERS, AND CONTROL PERSONS; COMPLIANCE WITH

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SECTION 16(A) OF THE EXCHANGE ACT: The Company will furnish to the Securities and Exchange Commission a definitive Proxy Statement (the "Proxy Statement") not later than 120 days after the close of its fiscal year ended June 30, 2002. The information required by this item is incorporated herein by reference to the Proxy Statement.

ITEM 10. EXECUTIVE COMPENSATION: The information required by this item is incorporated herein by reference to the Proxy Statement.

39

ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT: The information required by this item is incorporated herein by reference to the Proxy Statement.

ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS: The information required by this item is incorporated herein by reference to the Proxy Statement.

ITEM 13. EXHIBITS AND REPORTS ON FORM 8-K:

(a) EXHIBITS.

The exhibits listed below are filed with or incorporated by reference in this report.

- 3.1 Articles of Organization of the Company, as amended and corrected(1)
  - 3.2 By-laws of Precision Optics Corporation, Inc.(2)
  - 4.1 Specimen common stock certificate(3)
  - 4.2 Registration Rights Agreement dated as of March 17, 2000 by and among the Company and the Initial Investors as defined therein(4)
  - 4.3 Registration Rights Agreement dated as of June 30, 1998 by and among the Company, Special Situations Private Equity Fund, L.P. and Special Situations Technology Fund, L.P.(5)
  - 4.4 Registration Rights Agreement dated as of August 5, 1999 by and among the Company, Special Situations Cayman Funds, L.P., Special Situations Fund III, L.P., Special Situations Private Equity Fund, L.P. and Special Situations Technology Fund, L.P.(6)
  - 4.5 Form of Stock Purchase Warrant dated March 17, 2000 issued to each investor in March 17, 2000 private placement transaction(4)
  - 4.6 Warrant No. 1 dated March 17, 2000 issued to First Security Van Kasper(4)
  - 4.7 Warrant No. 2 dated March 17, 2000 issued to First Security Van Kasper(4)
  - 4.8 Common Stock Purchase Warrant dated August 5, 1999 issued to Special Situations Cayman Fund, L.P.(6)
- 40
- 4.9 Common Stock Purchase Warrant dated August 5, 1999 issued to Special Situations Technology Fund, L.P. (6)
  - 10.1 Lease dated June 29, 1984 between the Company and Equity, First



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- Amendment to Commercial Lease dated June 25, 1990, and letter agreement dated June 25, 1990 renewing such lease(3)
- 10.2 Second Amendment to Commercial Lease between the Company and Equity dated December 9, 1994(7)
- 10.3 Precision Optics Corporation, Inc. 1989 Stock Option Plan amended to date(8)
- 10.4 Three separate life insurance policies on the life of Richard E. Forkey.(3)
- 10.5 Master Lease Finance Agreement dated November 3, 1993 between the Company and BancBoston Leasing(8)
- 10.6 Lease dated March 1, 1999, between the Company and Philip A. Wood, as executor of the Estate of Alma L. Wood and as devisee under the Will of Alma L. Wood; Martha A. Mount, devisee under the Will of Alma L. Wood; and Nancy E. Popinchalk, devisee under the Will of Alma L. Wood for 21 Pleasant Street, Gardner, Massachusetts(6)
- 10.7 Precision Optics Corporation, Inc. 1997 Incentive Plan.(5)
- 10.8 Stock Subscription Agreement dated as of June 30, 1998 by and among the Company, Special Situations Private Equity Fund, L.P. and Special Situations Technology Fund, L.P.(5)
- 10.9 Stock Subscription Agreement dated as of August 5, 1999 by and among the Company, Special Situations Cayman Funds, L.P., Special Situations Fund III, L.P., Special Situations Private Equity Fund, L.P. and Special Situations Technology Fund, L.P.(6)
- 10.10 Securities Purchase Agreement dated as of March 13, 2000 by and among the Company and the Purchasers as defined therein (excluding exhibits)(4)
- 21 Subsidiaries of Precision Optics Corporation, Inc.(7)
- 23 Consent of KPMG LLP.
- 99.1 Important Factors Regarding Forward-Looking Statements.
- 99.2 Certification of Annual Report

- (1) Incorporated herein by reference to the Company's Registration Statement on Form S-8 (No. 333-97525).
- (2) Incorporated herein by reference to the Company's 1991 Annual Report on Form 10-KSB No. 001-10647.
- (3) Incorporated herein by reference to the Company's Registration Statement on Form S-18 (No. 33-36710-B).
- (4) Incorporated herein by reference to the Company's Registration Statement on Form S-3 (No. 333-35884).
- (5) Incorporated herein by reference to the Company's 1998 Annual Report on Form 10-KSB No. 001-10647.
- (6) Incorporated herein by reference to the Company's 1999 Annual Report on Form 10-KSB No. 001-10647.
- (7) Incorporated herein by reference to the Company's 1996 Annual Report on Form 10-KSB No. 001-10647.
- (8) Incorporated herein by reference to the Company's 1994 Annual Report on Form 10-KSB No. 001-10647.

41

(b) REPORTS ON FORM 8-K.

The Company filed two Current Reports on Form 8-K during the quarter ended June 30, 2002 as follows - (a) On April 4, 2002, the Company reported a press release issued April 3, 2002, reporting the first production shipment of autoclavable endoscopes and the receipt of new orders for medical products and (b) On April 30, 2002, the Company reported a press release issued April 26, 2002, reporting its

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operating results for the quarter ended March 31, 2002.

ITEM 14. CONTROLS AND PROCEDURES: There were no significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the date of the most recent evaluation of these controls by the Company's Chief Executive Officer and Chief Financial Officer, including any corrective actions with regard to significant deficiencies and material weaknesses.

42

SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: September 23, 2002

PRECISION OPTICS CORPORATION, INC.

By: /s/ Richard E. Forkey

-----  
Richard E. Forkey  
Chairman of the Board,  
Chief Executive Officer, President  
and Treasurer

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

By: /s/ Richard E. Forkey

-----  
Richard E. Forkey  
President, Treasurer and  
Director (principal  
executive officer)

Date: September 23, 2002

By: /s/ Joel R. Pitlor

-----  
Joel R. Pitlor  
Director

Date: September 23, 2002

By: /s/ Jack P. Dreimiller

-----  
Jack P. Dreimiller  
Senior Vice President, Finance,  
Chief Financial Officer and Clerk  
(principal financial and accounting  
officer)

Date: September 23, 2002

By: /s/ Edward A. Benjamin

-----  
Edward A. Benjamin  
Director

Date: September 22, 2002

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By: /s/ Robert R. Shannon

-----  
Robert R. Shannon  
Director

Date: September 22, 2002

By: /s/ H. Angus Macleod

-----  
H. Angus Macleod  
Director

Date: September 23, 2002

By: /s/ Austin W. Marxe

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Austin W. Marxe  
Director

Date: September 27, 2002

43

CERTIFICATIONS

I, Richard E. Forkey, certify that:

1. I have reviewed this annual report on Form 10-KSB of Precision Optics Corporation, Inc.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;

Date: September 23, 2002

/s/ Richard E. Forkey

-----  
Richard E. Forkey  
Chief Executive Officer

\* \* \* \* \*

I, Jack P. Dreimiller, certify that:

1. I have reviewed this annual report on Form 10-KSB of Precision Optics Corporation, Inc.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;

Date: September 23, 2002

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/s/ Jack P. Dreimiller

-----  
Jack P. Dreimiller  
Chief Financial Officer

44

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46