

PRECISION OPTICS CORPORATION INC  
Form 10QSB  
February 14, 2003

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**FORM 10-QSB**  
**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

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

For the Quarterly Period Ended December 31, 2002  
Commission file number 001-10647

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**PRECISION OPTICS CORPORATION, INC.**

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

**Massachusetts**  
(State or other jurisdiction of  
incorporation or organization)

**04-2795294**  
(IRS Employer Identification No.)

**22 East Broadway, Gardner, Massachusetts**  
(Address of principal executive offices)

**01440-3338**  
(Zip Code)

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

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Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No o

The number of shares outstanding of issuer's common stock, par value \$.01 per share, at February 13, 2003 was 1,752,052 shares.

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

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**PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES**

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**PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS**

|                           | <u>December 31, 2002</u><br>(Unaudited) | <u>June 30, 2002</u> |
|---------------------------|---|----------------------|
| <b>ASSETS</b>             |   |                      |
| <b>CURRENT ASSETS</b>     |   |                      |
| Cash and Cash Equivalents | \$ 4,589,217                            | \$ 5,825,601         |
| Accounts Receivable, Net  | 277,925                                 | 374,499              |
| Inventories               | 1,165,375                               | 1,009,009            |
| Prepaid Expenses          | 234,554                                 | 93,574               |
| Refundable Income Taxes   |   | 13,849               |
| Assets Held for Sale      | 278,192                                 | 847,696              |

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|   | December 31, 2002<br>(Unaudited) | June 30, 2002 |
|---|----------------------------------|---------------|
| Total Current Assets  | 6,545,263                        | 8,164,228     |
| <b>PROPERTY AND EQUIPMENT</b>   | 4,002,282                        | 3,983,698     |
| Less: Accumulated Depreciation  | (3,608,237)                      | (3,492,403)   |
| Net Property and Equipment  | 394,045                          | 491,295       |
| <b>OTHER ASSETS</b>   | 219,023                          | 224,516       |
| <b>TOTAL ASSETS</b>   | \$ 7,158,331                     | \$ 8,880,039  |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                                  |               |
| <b>CURRENT LIABILITIES</b>  |                                  |               |
| Current Portion of Capital Lease Obligation   | \$ 12,874                        | \$ 33,544     |
| Customer Advances   | 9,000                            | 30,000        |
| Accounts Payable  | 159,347                          | 118,901       |
| Accrued Payroll   | 100,315                          | 63,650        |
| Accrued Bonuses   | 30,000                           | 30,000        |
| Accrued Professional Services   | 67,655                           | 105,995       |
| Accrued Vacation  | 103,060                          | 121,042       |
| Accrued Warranty Expense  | 50,000                           | 50,000        |
| Accrued Income Taxes  |                                  | 912           |
| Other Accrued Liabilities   | 8,482                            | 24,509        |
| Accrued Restructuring Expense   |                                  | 167,971       |
| Total Current Liabilities   | 540,733                          | 746,524       |
| <b>CAPITAL LEASE OBLIGATION, Net of Current Portion, AND OTHER</b>                            | 4,665                            | 17,705        |
| <b>STOCKHOLDERS' EQUITY</b>   |                                  |               |
| Common Stock, \$.01 par value   |                                  |               |
| Authorized 20,000,000 shares  |                                  |               |
| Issued and Outstanding 1,752,052 shares at December 31, 2002 and June 30, 2002 <sup>(1)</sup> | 17,521                           | 17,521        |
| Additional Paid-in Capital <sup>(1)</sup>   | 27,770,175                       | 27,770,175    |
| Accumulated Deficit   | (21,174,763)                     | (19,671,886)  |
| Total Stockholders' Equity  | 6,612,933                        | 8,115,810     |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>   | \$ 7,158,331                     | \$ 8,880,039  |

(1) After giving effect to a 1-for-6 reverse stock split that became effective on January 29, 2003.

**PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**FOR THE SECOND QUARTER AND SIX MONTHS ENDED**  
**DECEMBER 31, 2002 AND 2001**

|  | SECOND QUARTER      |                     | SIX MONTHS          |                     |
|--|---------------------|---------------------|---------------------|---------------------|
|  | 2002<br>(UNAUDITED) | 2001<br>(UNAUDITED) | 2002<br>(UNAUDITED) | 2001<br>(UNAUDITED) |
| REVENUES   | \$ 589,759          | \$ 323,314          | \$ 1,132,202        | \$ 814,410          |
| COST OF GOODS SOLD   | 480,199             | 476,728             | 1,011,937           | 1,972,912           |
| Gross Profit (Loss)  | 109,560             | (153,414)           | 120,265             | (1,158,502)         |
| RESEARCH and DEVELOPMENT                                     | 339,137             | 737,187             | 649,193             | 1,412,897           |
| SELLING, GENERAL and<br>ADMINISTRATIVE EXPENSES              | 431,091             | 479,060             | 933,320             | 948,169             |
| PROVISION FOR ASSET IMPAIRMENT<br>and RESTRUCTURING          | 53,131              | 668,250             | 53,131              | 4,112,628           |
| Total Operating Expenses                                     | 823,359             | 1,884,497           | 1,635,644           | 6,473,694           |
| Operating Loss   | (713,799)           | (2,037,911)         | (1,515,379)         | (7,632,196)         |
| INTEREST INCOME  | 17,739              | 46,349              | 39,105              | 136,633             |
| INTEREST EXPENSE   | (324)               | (3,739)             | (6,562)             | (5,667)             |
| LOSS ON SALE OF ASSETS HELD FOR<br>SALE                      | (14,602)            |                     | (20,041)            |                     |
| Net Loss   | \$ (710,986)        | \$ (1,995,301)      | \$ (1,502,877)      | \$ (7,501,230)      |
| Basic and Diluted Loss Per Share <sup>(1)</sup>              | (\$ 0.41)           | (\$ 1.14)           | (\$ 0.86)           | (\$ 4.28)           |
| Weighted Average Common Shares<br>Outstanding <sup>(1)</sup> | 1,752,052           | 1,752,052           | 1,752,052           | 1,752,052           |

(1) After giving effect to a 1-for-6 reverse stock split that became effective on January 29, 2003.

**PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**FOR THE SIX MONTHS ENDED DECEMBER 31, 2002 AND 2001**  
**(UNAUDITED)**

|                                       | 2002           | 2001           |
|---------------------------------------|----------------|----------------|
| CASH FLOWS FROM OPERATING ACTIVITIES: |                |                |
| Net Loss                              | \$ (1,502,877) | \$ (7,501,230) |

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|   | 2002                | 2001                |
|---|---------------------|---------------------|
| <b>Adjustments to Reconcile Net Loss to Net Cash Used In Operating Activities</b> |                     |                     |
| Depreciation and Amortization   | 130,383             | 287,477             |
| Provision for Asset Impairment and Restructuring                                  | 53,131              | 4,112,628           |
| Provision for Inventory Writedown   |                     | 540,000             |
| Loss on Sale of Assets Held for Sale  | 20,041              |                     |
| Other   | (6,872)             | (19,418)            |
| <b>Changes in Operating Assets and Liabilities</b>                                |                     |                     |
| Accounts Receivable, Net  | 96,574              | 858,790             |
| Inventories   | (156,366)           | (121,123)           |
| Prepaid Expenses  | (140,980)           | (133,876)           |
| Refundable Income Taxes   | 13,849              |                     |
| Accounts Payable  | 40,446              | (478,709)           |
| Accrued Restructuring Expense   | (221,102)           | (113,159)           |
| Customer Advances   | (21,000)            |                     |
| Other Accrued Expenses  | (39,704)            | (126,598)           |
|   | <u>(1,734,477)</u>  | <u>(2,695,218)</u>  |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                     |                     |
| Purchases of Property and Equipment   | (16,321)            | (58,554)            |
| Net Proceeds from Sale of Assets Held for Sale                                    | 550,091             |                     |
| Increase in Other Assets  | (11,948)            | (22,348)            |
|   | <u>521,822</u>      | <u>(80,902)</u>     |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                     |                     |
| Repayment of Capital Lease Obligation   | (23,729)            | (14,347)            |
|   | <u>(23,729)</u>     | <u>(14,347)</u>     |
| <b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>                                  | <b>(1,236,384)</b>  | <b>(2,790,467)</b>  |
| <b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>                           | <b>5,825,601</b>    | <b>10,530,298</b>   |
|   | <u>\$ 4,589,217</u> | <u>\$ 7,739,831</u> |
| <b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>                          |                     |                     |
| <b>Cash Paid for</b>  |                     |                     |
| Interest  | \$ 6,562            | \$ 5,667            |
|   | <u>\$ 1,824</u>     | <u>\$ 912</u>       |

**PRECISION OPTICS CORPORATION, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

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The accompanying consolidated financial statements include the accounts of Precision Optics Corporation, Inc. and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. All shares and per share data reflect the effects of a 1-for-6 reverse stock split that became effective on January 29, 2003.

These consolidated financial statements have been prepared by the Company, without audit, and reflect normal recurring adjustments which, in the opinion of management, are necessary for a fair statement of the results of the second quarter and first half of the Company's fiscal year 2003. These consolidated financial statements do not include all disclosures associated with annual consolidated financial statements and, accordingly, should be read in conjunction with footnotes contained in the Company's consolidated financial statements for the year ended June 30, 2002 together with the auditors' report filed under cover of the Company's 2002 Annual Report on Form 10-KSB.

Basic loss per share is computed by dividing net loss by the weighted average number of shares of common stock outstanding during the period. For the six months ended December 31, 2002 and 2001, the effect of stock options and warrants was antidilutive; therefore, they were not included in the computation of diluted loss per share. The number of shares issuable upon the exercise of outstanding stock options and warrants that were excluded from the computation as their effect would be antidilutive were approximately 203,748 and 184,100, for the six months ended December 30, 2002 and 2001, respectively.

### 2. INVENTORIES

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

|                   | December 31,<br>2002 | June 30,<br>2002 |
|-------------------|----------------------|------------------|
| Raw Materials     | \$ 638,770           | \$ 532,228       |
| Work-In-Progress  | 331,675              | 302,128          |
| Finished Goods    | 194,930              | 174,653          |
| Total Inventories | \$ 1,165,375         | \$ 1,009,009     |

### 3. EXPENSE REDUCTION

In October 2002, the Company reduced its full-time workforce by approximately 16%, or six employees. As a result of this action, the Company recorded a non-recurring pretax charge to earnings of \$53,131 for employee severance benefits that were paid in the quarter ended December 31, 2002.

### 4. SUBSEQUENT EVENT

Effective as of the open of business on January 29, 2003 (the "Effective Time"), the Company effected a reverse stock split (the "Reverse Stock Split") of its Common Stock, par value \$.01 per share (the "Common Stock"). The purpose of the Reverse Stock Split, which was approved by the shareholders of the Company at the Annual Meeting of Shareholders held in November 2002 and which the Board of Directors determined to be in the best interests of the Company and its shareholders, was to increase the per share price of the Company's Common Stock in order to comply with the minimum bid price listing requirement of Nasdaq. As previously disclosed, the Company had

been notified that it was not in compliance with the \$1.00 minimum share price requirement for continued listing on the Nasdaq SmallCap Market. In order to regain compliance, the bid price of the Company's Common Stock had to close at or above \$1.00 per share for a minimum of 10 consecutive trading days. On each of the 10 consecutive trading days including and following January 29, 2003, the bid price of the Company's Common Stock closed at or above \$1.00 per share. Accordingly, the Company believes that it has regained compliance with the minimum share price requirement for continued listing on the Nasdaq SmallCap Market. There can be no assurance, however, that the market price of the Common Stock will not subsequently decrease to a level that causes the Company to again face de-listing, or that the Company's market capitalization will not subsequently be less than its market capitalization before the Reverse Stock Split.

At the Effective Time, every six shares of Common Stock were reclassified and combined into one share of Common Stock. No fractional shares were issued as a result of the Reverse Stock Split. Instead, each resulting fractional share of Common Stock was rounded up to one whole share. The Reverse Stock Split reduced the number of shares of Common Stock outstanding from 10,503,908 to 1,752,052. Immediately after

the Effective Time, the total number of authorized shares of Common Stock continued to be 20,000,000 and the par value per share of the Common Stock continued to be \$.01.

All shares and per share data in the accompanying consolidated financial statements reflect the effects of the 1-for-6 Reverse Stock Split that became effective on January 29, 2003. In addition, capital stock has been decreased by \$87,518, with a corresponding increase to paid-in capital to reflect the adjusted number of shares of \$.01 per value common stock outstanding as a result of the 1-for-6 Reverse Stock Split.

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## PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

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

#### Important Factors Regarding Forward-Looking Statements

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

#### Critical Accounting Policies and Estimates

##### *General*

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

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

##### *Revenue Recognition*

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

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*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*

On July 1, 2002, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. SFAS No. 144 supercedes 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 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.

**Results of Operations**

Total revenues for the quarter and six months ended December 31, 2002 increased by \$266,445 or 82.4% and \$317,792 or 39.0%, respectively, from the same periods in the prior year. Revenues for the quarter increased 8.7% sequentially from the preceding quarter.

The increase in revenues for the quarter was due primarily to higher sales of medical products (up by approximately \$293,000, or 112%), partially offset by lower sales of non-medical products (down by approximately \$26,000, or 43%). Sales of medical products were higher due primarily to higher shipments of stereo endoscopes and cameras.

The revenue increase from the prior year for the six months ended December 31, 2002 was due to higher sales of medical products (up approximately \$497,000, or 89%), partially offset by lower sales of non-medical products (down approximately \$179,000 or 70%). For the six months ended December 31, 2002, medical sales were higher due primarily to higher shipments of stereo endoscopes and cameras. Non-medical sales were lower due primarily to the discontinuation of sales of Dense Wavelength Division Multiplexing (DWDM) filters.

Revenues from the Company's largest customers, as a percentage of total revenues for the six months ended December 31, 2002 and 2001, were as follows:

|            | <u>2002</u> | <u>2001</u> |
|------------|-------------|-------------|
| Customer A | 36          |             |
| Customer B | 15          | 19          |
| Customer C | 10          | 5           |
| Customer D | 6           | 19          |
| Customer E | 2           | 12          |
| Customer F |             | 13          |



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|            | 2002 | 2001 |
|------------|------|------|
| All Others | 31   | 32   |
|            | 100% | 100% |

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

At December 31, 2002, receivables from the Company's three largest customers were approximately 39%, 24% and 14%, respectively, of the total accounts receivable. At June 30, 2002, receivables from the Company's largest customer were approximately 63% of the total accounts receivable. No other customer accounted for more than 10% of the Company's receivables as of December 31, 2002 and June 30, 2002.

Gross profit for the quarter and six months ended December 31, 2002 reflected a favorable change of approximately \$263,000 and \$1,279,000, respectively, compared to the quarter and six months ended December 31, 2001. Gross profit as a percentage of revenues increased from a negative 47.5% in the quarter ended December 31, 2001 to 18.6% in the current quarter, and increased from a negative 142.3% in the six months ended December 31, 2001 to 10.6% in the six months ended December 31, 2002. The favorable 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 quarter ended September 30, 2001; (2) lower fixed manufacturing costs resulting from the cessation of operations in the Company's optical thin film technology facility and reductions in staff; and (3) the higher overall sales volume.

Research and development expenses decreased by approximately \$398,000, or 54.0%, for the quarter ended December 31, 2002, and by approximately \$764,000, or 54.1%, for the six months ended December 31, 2002 compared to the corresponding periods of the prior year. During the prior year, research and development expenses consisted primarily of development efforts related to DWDM filters used in telecommunications systems. The decrease in the current year was due to discontinuation of the development of DWDM filters, as reflected in reductions in staff, and the remaining R&D resources being redeployed toward development of new medical products.

Selling, general and administrative expenses decreased by approximately \$48,000, or 10.0%, for the quarter ended December 31, 2002 and by approximately \$15,000, or 1.6%, for the six months ended December 31, 2002 compared to the corresponding periods of the prior year. The decrease is due primarily to lower sales and marketing expenses.

The provision for asset impairment and restructuring of \$53,131 in the quarter and six months ended December 31, 2002, consists of a provision for severance benefits paid in the quarter ended December 31, 2002 related to the October 2002 workforce reduction of 16%, or six employees. The provision for asset and impairment and restructuring of \$668,250 and \$4,112,628 in the quarter and six months ended December 31, 2001, respectively consists of (1) a provision for restructuring costs recorded in the quarter ended December 31, 2001, representing the present value of future lease payments related to idle space in the Company's former Optical Thin Film Technology Center, and employee severance costs; and (2) a provision for asset impairment of \$3,444,378 recorded in the

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quarter ended September 30, 2001, representing a writedown to the lower of carrying value or fair market value of certain of the Company's property and equipment invested in its optical thin films coating business.

Interest expense relates primarily to capital lease obligations.

Interest income decreased by approximately \$29,000 for the quarter and by \$98,000 for the six months ended December 31, 2002 compared to the corresponding periods of the prior year due to the lower base of cash and cash equivalents and to lower interest rates.

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

No income tax provision was recorded in the first or second quarters of fiscal year 2003 or 2002 because of the losses generated in those periods.

**Liquidity and Capital Resources**

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For the six months ended December 31, 2002, the Company's cash and cash equivalents decreased by approximately \$1,236,000 to \$4,589,000. The decrease in cash and cash equivalents was due to cash used by operating activities of approximately \$1,734,000, capital expenditures of approximately \$16,000, repayment of debt of approximately \$24,000, and an increase in other assets of approximately \$12,000, partially offset by net proceeds received from the sale of assets of approximately \$550,000.

Contractual cash commitments for the fiscal years subsequent to December 31, 2002 are summarized as follows:

|                  | 2003             | 2004             | Thereafter | Total            |
|------------------|------------------|------------------|------------|------------------|
| Capital leases   | \$ 8,765         | \$ 3,874         | \$         | \$ 12,639        |
| Operating leases | 27,671           | 15,383           |            | 43,054           |
| <b>Total</b>     | <b>\$ 36,436</b> | <b>\$ 19,257</b> | <b>\$</b>  | <b>\$ 55,693</b> |

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

The Company 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

Statement of Financial Accounting Standards ("SFAS") No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure an amendment of SFAS No. 123 (Issued 12/02) amends SFAS No. 123, Accounting for Stock-Based Compensation*, to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this Statement amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results.

This Statement seeks to improve the prominence and clarity of the pro forma disclosures required by SFAS No. 123 by prescribing a specific tabular format and by requiring disclosure in the "Summary of Significant Accounting Policies" or its equivalent. In addition, this Statement seeks to improve the timeliness of those disclosures by requiring their inclusion in financial reports for interim periods.

The provisions of SFAS No. 148 generally will be effective for fiscal years ended after December 15, 2002. The disclosures to be provided in annual financial statements will be required for fiscal years ended after December 15, 2002, and the disclosures to be provided in interim financial reports will be required for interim periods begun after December 15, 2002, with earlier application encouraged.

The Company will comply with the disclosure requirement of the Statement beginning with the interim period ending March 31, 2003. However, the Company currently intends to retain the intrinsic value method of accounting for stock-based employee compensation as allowed by SFAS No. 123.

FASB Interpretation 45, an interpretation of SFAS No.'s 5, 57 and 107 (and rescission of FASB Interpretation No. 34), *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, introduces the concept of two different obligations related to the issuance of a guarantee: (1) the contingent obligation to make future payments under the conditions of the guarantee and (2) the non-contingent obligation to stand ready to perform (stand-ready obligation). Interpretation 45 addresses the accounting for the stand-ready obligation under the guarantee, while SFAS No. 5, *Accounting for Contingencies*, addresses the recognition and measurement of the contingent obligation. A guarantor is required to recognize a liability with respect to its stand-ready obligation under the guarantee even if the probability of future payments under the conditions of a guarantee is remote. The initial liability will be measured as the fair value of the stand-ready obligation. The Interpretation excludes certain guarantees from its scope while others are excluded solely from the recognition requirements (i.e., subject to disclosure only). The disclosure requirements are effective for interim and annual financial statements ending after December 15, 2002 (December 31, 2002 financial statements for calendar year companies). The initial recognition and measurement provisions are effective for all guarantees within the scope of Interpretation 45 issued or modified after December 31, 2002.

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Adoption of FASB Interpretation 45 as of December 31, 2002 will not have an effect on the Company's financial statements.

FASB Interpretation No. 46, issued in January 2003, is an interpretation of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, and addresses consolidation by business enterprises of variable interest entities. This Interpretation requires existing unconsolidated variable interest entities to be consolidated by their primary beneficiaries if the entities do not effectively disperse risks among parties involved. Variable interest entities that effectively disperse risks will not be consolidated unless a single party holds an interest or combination of interests that effectively recombinates risks that were previously dispersed.

This Interpretation applies immediately to variable interest entities created after January 31, 2003, and to variable interest entities in which an enterprise obtains an interest after that date. It applies in the first fiscal year or interim period beginning after June 15, 2003, to variable interest entities in which an enterprise holds a variable interest that it acquired before February 1, 2003. The Interpretation applies to public enterprises as of the beginning of the applicable interim or annual period, and it applies to nonpublic enterprises as of the end of the applicable annual period.

The Company does not expect that the adoption of FASB Interpretation No. 46 will have a significant effect on its consolidated financial statements.

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### **Expense Reduction**

The Company has taken additional measures to realign its cost structure with current revenue expectations. In October 2002, the Company reduced its full-time workforce by approximately 16%, or six employees. As a result of this action, the Company recorded a non-recurring pretax charge to earnings of approximately \$53,000 for employee severance benefits in the quarter ended December 31, 2002. In addition, the Company is in the process of reviewing other expense areas to determine where additional reductions in discretionary spending can be achieved.

### **Trends and Uncertainties That May Affect Future Results**

For the quarter ended December 31, 2002, cash and cash equivalents decreased by approximately \$500,000 from September 30, 2002. Cash receipts during the quarter included approximately \$545,000 related to the sale of certain assets held for sale. Cash disbursements during the quarter included approximately \$414,000 for certain non-recurring payments (such as employee severance and legal expenses associated with corporate governance issues and other matters), and certain payments occurring only during the second quarter each year (such as annual insurance premiums and costs associated with preparation of annual shareholder proxy materials). Cash disbursements in the preceding quarter ended September 30, 2002 included a non-recurring payment for lease cancellation of approximately \$168,000. Excluding these incremental receipts and disbursements, cash usage during the quarter ended December 31, 2002 would have been approximately \$631,000, an 11% sequential increase in cash usage compared to the previous quarter ended September 30, 2002. This increased cash usage is attributable primarily to higher inventory purchases and customer receivables (net of advances) to support the higher sales levels in the quarter ended December 31, 2002.

During the quarter ended December 31, 2002, the Company received net proceeds of approximately \$545,000 related to the sale of a portion of its assets held for sale (the property and equipment previously used in the Company's telecommunications product line). The remaining assets in this category are anticipated to be sold by June 30, 2003.

Capital equipment expenditures during the six months ended December 31, 2002 were approximately \$16,000, down 72% from the six months ended December 31, 2001. Future capital expenditures will be dependent upon future sales and success of on-going research and development efforts.

For the quarter ended December 31, 2002, research and development expenses were approximately \$339,000, down 54% from the \$737,000 in the quarter ended December 31, 2001. It is anticipated that the quarterly level of R&D expenses for the foreseeable future will remain in this lower range, but is ultimately dependent upon the Company's assessment of new product opportunities.

The Company's new medical products and certain non-medical applications of its optical technology have been well received by the marketplace. Some of these new products include:

Stereo endoscope systems (used in cardiac surgery and a growing number of other minimally invasive surgical procedures).

30° line of sight version of the successful 5 mm autoclavable laparoscope.

4 mm short endoscope (used in carpal tunnel surgery).

Longer version of the 10 mm laparoscope (used in bariatric surgery for treatment of morbid obesity).

5 mm 30° endoscope (used in vessel transplant for cardiac bypass surgery).

Relay lens system (for use in medical digital photo microscopy).

Episcope (for use in examination of the epidermis).

These initiatives alone have already generated orders from new and existing customers totaling approximately \$1,272,000, of which approximately \$83,000 was shipped in fiscal year 2002,

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approximately \$181,000 was shipped in the quarter ended September 30, 2002, and approximately \$360,000 was shipped in the quarter ended December 31, 2002. A positive trend in shipments is expected to continue during the quarter ending March 31, 2003.

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**

Effective as of the open of business on January 29, 2003 (the "Effective Time"), the Company effected a reverse stock split (the "Reverse Stock Split") of its Common Stock, par value \$.01 per share (the "Common Stock"). The purpose of the Reverse Stock Split, which was approved by the shareholders of the Company at the Annual Meeting of Shareholders held in November 2002 and which the Board of Directors determined to be in the best interests of the Company and its shareholders, was to increase the per share price of the Company's Common Stock in order to comply with the minimum bid price listing requirement of Nasdaq. As previously disclosed, the Company had been notified that it was not in compliance with the \$1.00 minimum share price requirement for continued listing on the Nasdaq SmallCap Market. In order to regain compliance, the bid price of the Company's Common Stock had to close at or above \$1.00 per share for a minimum of 10 consecutive trading days. On each of the 10 consecutive trading days including and following January 29, 2003, the bid price of the Company's Common Stock closed at or above \$1.00 per share. Accordingly, the Company believes that it has regained compliance with the minimum share price requirement for continued listing on the Nasdaq SmallCap Market. There can be no assurance, however, that the market price of the Common Stock will not subsequently decrease to a level that causes the Company to again face de-listing, or that the Company's market capitalization will not subsequently be less than its market capitalization before the Reverse Stock Split.

At the Effective Time, every six shares of Common Stock were reclassified and combined into one share of Common Stock. No fractional shares were issued as a result of the Reverse Stock Split. Instead, each resulting fractional share of Common Stock was rounded up to one whole share. The Reverse Stock Split reduced the number of shares of Common Stock outstanding from 10,503,908 to 1,752,052. Immediately after the Effective Time, the total number of authorized shares of Common Stock continued to be 20,000,000 and the par value per share of the Common Stock continued to be \$.01.

#### **Item 3 Controls and Procedures**

- (a) *Evaluation of Disclosure Controls and Procedures.* The Company's Chief Executive Officer and Chief Financial Officer have conducted an evaluation of the Company's disclosure controls and procedures as of a date within 90 days of filing this quarterly report. Based on their evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the applicable Securities and Exchange Commission rules and forms.
- (b) *Changes in Internal Controls and Procedures.* There were no significant changes in the



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I, Richard E. Forkey, certify that:

1. I have reviewed this quarterly report on Form 10-QSB of Precision Optics Corporation, Inc.;
2. Based on my knowledge, this quarterly 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 quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly 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 quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

DATE: February 13, 2003

/s/ RICHARD E. FORKEY

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Richard E. Forkey  
*Chief Executive Officer*

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**CERTIFICATIONS**

I, Jack P. Dreimiller, certify that:

1. I have reviewed this quarterly report on Form 10-QSB of Precision Optics Corporation, Inc.;
2. Based on my knowledge, this quarterly 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 quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly 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 quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

DATE: February 13, 2003

/s/ JACK P. DREIMILLER

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Jack P. Dreimiller  
*Chief Financial Officer*

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## QuickLinks

[PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES](#)

[PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS](#)

[PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF OPERATIONS FOR THE SECOND QUARTER AND SIX MONTHS ENDED DECEMBER 31, 2002 AND 2001](#)

[PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE SIX MONTHS ENDED DECEMBER 31, 2002 AND 2001 \(UNAUDITED\)](#)

[PRECISION OPTICS CORPORATION, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS](#)

[PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES Management's Discussion and Analysis of Financial Condition and Results of Operations](#)

[CERTIFICATIONS](#)

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