PRECISION OPTICS CORPORATION INC
Form 10-Q
February 16, 2010

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended December 31, 2009

or

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

For the transition period from to

Commission File Number: 001-10647

PRECISION OPTICS CORPORATION, INC.

(Exact name of registrant as specified in its charter)

Massachusetts	**04-2795294**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

22 East Broadway, Gardner, Massachusetts 01440-3338

(Address of principal executive offices) (Zip Code)

(978) 630-1800

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

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

Large accelerated filer o	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company x

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

The number of shares outstanding of the issuer s common stock, par value $0.01 per share, at February 16, 2010 was 1,018,411 shares.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

	December 31, 2009	June 30, 2009
ASSETS		
CURRENT ASSETS		
Cash and Cash Equivalents	$ 216,560	$ 384,593
Accounts Receivable, net	483,983	511,807
Inventories, net	730,845	709,155
Prepaid Expenses	51,883	42,617
Total Current Assets	1,483,271	1,648,172
PROPERTY AND EQUIPMENT		
Machinery and Equipment	2,353,697	2,352,634
Leasehold Improvements	553,596	553,596
Furniture and Fixtures	148,303	148,303
Vehicles	42,343	42,343
	3,097,939	3,096,876
Less: Accumulated Depreciation	(2,994,162)	(2,968,503)
Net Property and Equipment	103,777	128,373
OTHER ASSETS		
Patents, net	202,717	198,643
TOTAL ASSETS	$ 1,789,765	$ 1,975,188
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES		
10% Senior Secured Convertible Notes	$ 593,854	$ 464,104
Accounts Payable	424,538	428,282
Customer Advances	112,568	12,393
Accrued Employee Compensation	568,582	504,187
Accrued Professional Services	51,190	58,000
Accrued Warranty Expense	25,000	25,000
Other Accrued Liabilities		912
Total Current Liabilities	1,775,732	1,492,878
STOCKHOLDERS EQUITY		
Common Stock, $0.01 par value - Authorized - 50,000,000 shares Issued and Outstanding 1,018,411 shares at December 31, 2009 and at June 30, 2009	10,184	10,184
Additional Paid-in Capital	38,229,973	38,222,002
Accumulated Deficit	(38,226,124)	(37,749,876)
Total Stockholders Equity	14,033	482,310
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 1,789,765	$ 1,975,188

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

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE THREE AND SIX MONTHS ENDED

DECEMBER 31, 2009 AND 2008

(UNAUDITED)

	Three Months Ended December 31, 2009	Three Months Ended December 31, 2008	Six Months Ended December 31, 2009	Six Months Ended December 31, 2008
Revenues	$ 686,036	$ 960,714	$ 1,309,420	$ 1,620,449
Cost of Goods Sold	447,277	470,429	851,635	826,026
Gross Profit	238,759	490,285	457,785	794,423
Research and Development Expenses, net	180,016	139,070	194,663	315,680
Selling, General and Administrative Expenses	300,617	387,982	613,303	759,931
Gain on Sale of Assets	(2,483)		(3,353)	
Total Operating Expenses	478,150	527,052	804,613	1,075,611
Operating Loss	(239,391)	(36,767)	(346,828)	(281,188)
Interest Income	168	1,479	330	4,430
Interest Expense	(64,875)	(138,575	(129,750)	(324,050
Net Loss	$ (304,098)	$ (173,863)	$ (476,248)	$ (600,808)
Loss Per Share - Basic and Diluted	$ (0.30)	$ (0.17)	$ (0.47)	$ (0.59)
Weighted Average Common Shares Outstanding - Basic and Diluted	1,018,411	1,018,411	1,018,411	1,018,411

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

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE SIX MONTHS ENDED

DECEMBER 31, 2009 AND 2008

(UNAUDITED)

	Six Months Ended December 30, 2009	2008
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net Loss	$ (476,248)	$ (600,808)
Adjustments to Reconcile Net Loss to Net Cash Used In Operating Activities -		
Depreciation and Amortization	42,130	32,565
Gain on Sale of Assets	(3,353)	
Stock-based Compensation Expense	7,971	34,452
Non-cash Interest Expense	129,750	324,050
Changes in Operating Assets and Liabilities-		
Accounts Receivable, net	27,824	(292,123)
Inventories	(21,690)	(18,229)
Prepaid Expenses	(9,266)	(15,668)
Accounts Payable	(3,744)	51,947
Customer Advances	100,175	(78,712)
Accrued Expenses	56,673	20,724
Net Cash Used In Operating Activities	(149,778)	(541,802)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of Property and Equipment	(1,063)	
Proceeds from Sale of Assets	3,353	
Additional Patent Costs	(20,545)	(5,062)
Net Cash Used By Investing Activities	(18,255)	(5,062)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(168,033)	(546,864)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	384,593	885,988
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 216,560	$ 339,124
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash Paid for-		
Income Taxes	$ 912	$ 912

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

PRECISION OPTICS CORPORATION, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation and Operations

The accompanying consolidated financial statements include the accounts of Precision Optics Corporation, Inc. and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. All shares and per share data reflect the 1-for-25 reverse stock split that became effective on December 11, 2008.

These consolidated financial statements have been prepared by the Company, without audit, and reflect normal recurring adjustments which, in the opinion of management, are necessary for a fair statement of the results of the second quarter of the Company s fiscal year 2010. 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, 2009 together with the Report of Independent Registered Public Accounting Firm filed under cover of the Company s 2009 annual report on Form 10-K.

The Company has sustained recurring net losses and negative cash flows from operations for several years. During the quarter ended December 31, 2009, the Company incurred a net loss of $304,098 and used cash in operations of $149,778. As of December 31, 2009, cash and cash equivalents were $216,560, accounts receivable were $483,983 and current liabilities were $1,775,732. The Company anticipates that deferred officers salaries and director consulting expenses accrued at December 31, 2009 will be settled by issuing restricted common stock rather than by cash payments. These deferred amounts included in current liabilities at December 31, 2009 total approximately $450,000. These factors raise substantial doubt about the Company s ability to continue as a going concern. The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts and classification of liabilities that might be necessary should the Company be unable to continue as a going concern. During the latter part of fiscal year 2008, the Company implemented plans to reduce costs and to streamline operations in an effort to reduce net losses. This has resulted in an increase in gross profit and simultaneous decreases in operating expenses, thereby reducing losses substantially, beginning in the third and fourth quarters of fiscal year 2008. The Company believes that the recent introduction of several new products, along with new and on-going customer relationships, will generate additional revenues, which are required in order for the Company to achieve profitability. If these additional revenues are not achieved on a timely basis, the Company will be required and is prepared to implement further cost reduction measures, as necessary.

The Company has incurred quarter to quarter operating losses during its recent efforts to develop current products including endoscopes, image couplers, beamsplitters, thin film coatings, night vision and micro-optic lenses, prisms and assemblies for various applications and utilizing a number of proprietary and patent-pending technologies including Lenslock endoscope and micro-precision lens technologies. Management expects that such operating losses will continue through fiscal year 2010, and until sales increase to breakeven and profitable levels. Management also believes that the opportunities represented by these products have the potential to generate sales increases to achieve breakeven and profitable results. The Company will continue its review of other expense areas to determine where additional reductions in discretionary spending can be achieved. There can be no assurance that the Company s operating plans will be successful, and if so required, that the Company will be successful in obtaining the capital necessary to continue ongoing operations.

In June 2008, the Company issued senior secured convertible notes and warrants, raising cash proceeds of $600,000.

Use of Estimates

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

Loss Per Share

Basic loss per share is computed by dividing net loss by the weighted average number of shares of common stock outstanding during the period. For the three and six months ended December 31, 2009 and 2008, 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 were approximately 992,000 for each of the three and six month periods ended December 31, 2009 and 2008, respectively.

Revenue Recognition

The Company recognizes revenue in accordance with Securities and Exchange Commission Staff Accounting Bulletin No. 104, *Revenue Recognition* (SAB No. 104) which requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services rendered; (3) the price to the buyer is fixed or determinable; and (4) collectability is reasonably assured. The Company s shipping terms are customarily FOB shipping point. The Company s revenue recognition practices comply with the guidance in the bulletin.

Inventories

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

Long-lived assets and certain identifiable intangibles are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to undiscounted future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less estimated costs to sell.

Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

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

Subsequent Events

The Company adopted Accounting Standards Codification (ASC) 855, Subsequent Events (ASC 855). ASC 855 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or available to be issued. The adoption of ASC 855 did not have a material impact on the Company s consolidated results of operations or financial condition. The Company has evaluated subsequent events through February 16, 2010, the date the financial statements were issued.

2. INVENTORIES

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

		December 31, 2009		June 30, 2009
Raw Materials	$	359,693	$	492,712
Work-In-Progress		190,090		116,605
Finished Goods		181,062		99,838
Total Inventories	$	730,845	$	709,155

3. 10% SENIOR SECURED CONVERTIBLE NOTES

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

		December 31, 2009		June 30, 2009
10% Senior Secured Convertible Notes issued on June 25, 2008, convertible into common stock at $1.25 per share, bearing interest at 10% per annum. Outstanding principal and accrued interest are due at maturity, June 25, 2010	$	600,000	$	600,000
Accrued interest 10% coupon		90,833		60,833
Unamortized discount		(96,979)		(196,729)
	$	593,854	$	464,104

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

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

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

The following summarizes the discount on the Notes:

		December 31, 2009		June 30, 2009
Discount beginning balance	$	196,729	$	590,529
Proceeds allocated to warrants				
Beneficial conversion feature intrinsic value				
Less: amortization of discount		(99,750)		(393,800)
Discount ending balance	$	96,979	$	196,729

4. <u>STOCK-BASED COMPENSATION</u>

Stock-based compensation costs recognized during the three and six month periods ended December 31, 2009 amounted to $4,795 and $7,971, respectively, and for the three and six month periods ended December 31, 2008 amounted to $20,392 and $34,452, respectively, and was included in the accompanying consolidated statements of operations. No compensation has been capitalized because such amounts would have been immaterial. There was no net income tax benefit recognized related to such compensation for the three and six month periods ended December 31, 2009 and 2008, as the Company is currently in a loss position.

As of December 31, 2009, the unrecognized compensation costs related to options vesting will be primarily recognized over a period of approximately 1 1/2 years:

OPTIONS	**2010**	**2011**	**Total**
Compensation Expense	$ 6,352	$ 12,703	$ 19,055

The following tables summarize stock option activity during the first six months of fiscal year 2010:

	Number of Shares		Options Outstanding Weighted Average Exercise Price		Weighted Average Contractual Life
Outstanding at June 30, 2009	93,178	$	16.17		6.56 years
Grants	1,200		1.35		
Outstanding at December 31, 2009	94,378	$	15.98	$	7.06 years

Information related to the stock options outstanding as of December 31, 2009 is as follows:

Range of Exercise Prices	Number of Shares	Weighted-Average Remaining Contractual Life (years)	Weighted-Average Exercise Price	Exercisable Number of Shares	Exercisable Weighted-Average Exercise Price
$1.25	1,200	8.91	$ 1.25	1,200	$ 1.25
$1.35	1,200	9.90	1.35	1,200	1.35
$6.25	1,600	6.92	6.25	1,600	6.25
$7.75	1,200	7.91	7.75	1,200	7.75
$11.50	800	5.92	11.50	800	11.50
$13.75	51,018	6.36	13.75	49,685	13.75
$20.75	37,360	5.46	20.75	37,360	20.75
$1.25-$20.75	94,378	5.98	$ 15.98	93,045	$ 16.00

There were no in-the-money outstanding and exercisable options as of June 30, 2009 and December 31, 2009.

5. STOCKHOLDERS EQUITY

Registration Statement

On December 18, 2008, the Company filed a registration statement on Form S-1 to register 1,074,621 shares of common stock, which included 480,000 shares underlying Senior Secured Convertible Notes, 96,000 shares underlying potential interest due on the Notes and 498,621 shares underlying warrants. The Company filed an amendment to the Form S-1 on April 6, 2009, reducing the number of shares being registered to 960,439 shares, which included 480,000 shares underlying the Notes and 480,439 shares underlying warrants. The Company will not receive any proceeds from the sale or other disposition of common stock by the selling stockholders. The Company may receive proceeds from the exercise of warrants. On June 29, 2009, the registration statement was declared effective by the U.S. Securities and Exchange Commission.

Reverse Stock Split

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

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

Warrants

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

In February 2007, the Company completed a private placement with institutional and other accredited investors pursuant to which it sold an aggregate of 400,000 shares of common stock, at a price of $6.25 per share and warrants to purchase an aggregate of 400,000 shares of common stock at an exercise price of $8.00 per share. In conjunction with the issuance by the Company of the 10% Senior Secured Convertible Notes and warrants on June 25, 2008, certain anti-dilution provisions of the existing warrants were triggered. As a result, the number of existing warrants was increased from 400,000 to 581,821 and the related exercise price was decreased from $8.00 per share to $5.50 per share. The warrants expire on February 1, 2012.

7. SALE OF ASSETS

During the six months ended December 31, 2009, the Company sold equipment that was previously written off for proceeds totaling $3,353 and recorded a gain of $3,353, which is included within operating expenses in the accompanying consolidated statements of operations.

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

Important Factors Regarding Forward-Looking Statements

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

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

Overview

We have been a developer and manufacturer of advanced optical instruments since 1982. We design and produce high-quality micro-optics, medical instruments and other advanced optical systems. Our medical instrumentation line includes laparoscopes, arthroscopes and endocouplers and a world-class product line of 3-D endoscopes for use in minimally invasive surgical procedures.

We are currently developing specialty instruments incorporating our Lenslock technology (patent pending) that ensures lower cost, easier reparability and enhanced durability as compared to other design approaches used in the industry. We are also aggressively pursuing ultra-small instruments, some with lenses less than 1 millimeter, or mm, in diameter, utilizing micro-precision lens technology (patent pending).

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

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

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

We believe that our future success depends to a large degree on our ability to continue to conceive and to develop new optical products and services to enhance the performance characteristics and methods of manufacture of existing products. Accordingly, we expect to continue to seek to obtain product-related design and development contracts with customers and to invest our own funds on research and development, to the extent funds are available.

Critical Accounting Policies and Estimates

General

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

There have been no significant changes in the critical accounting policies disclosed in our annual report on Form 10-K for the year ended June 30, 2009.

Results of Operations

During the latter part of fiscal year 2008, we implemented plans to reduce costs, including workforce reductions, to focus sales efforts on higher margin products and to streamline operations in an effort to reduce net losses. These efforts, combined with recent increases in sales, resulted in an increase in gross profit and a simultaneous decrease in operating expense beginning in the third quarter of fiscal year 2008 and continuing through the quarter ended June 30, 2009. We anticipate continuing the measures taken to contain costs, and to continue our review of other expense areas to determine where additional reductions in spending can be achieved.

Our total revenues for the quarter ended December 31, 2009 were $686,036, as compared to $960,714 for the same period last year, a decrease of $274,678, or 28.6%. Our total revenues for the six months ended December 31, 2009 were $1,309,420, as compared to $1,620,449 for the same period last year, a decrease of $311,029, or 19.2%. The decrease in revenues for the current quarter and six months ended December 31, 2009 was due principally to lower sales of optical components, rigid endoscopes and fiber scopes, partially offset by higher sales of the advanced surgical visualization system used in spinal surgery. Revenues from our largest customers, as a percentage of total revenues, for the six months ended December 31, 2009 and 2008, were as follows:

	2009	2008
Customer A	26%	8%
Customer B	23	18
Customer C	20	32
Customer D	12	12
All Others	19	30
	100%	100%

No other customer accounted for more than 10% of our revenues during those periods.

Gross profit for the quarter ended December 31, 2009 was $238,759, which reflects a decrease of $251,526, compared to $490,285 for the same period last year. Gross profit for the quarter ended December 31, 2009 as a percentage of revenues decreased from 51.0% for the quarter ended December 31, 2008 to 34.8% in the current year. Gross profit for the six months ended December 31, 2009 was $457,785, which reflects a decrease of $336,638, compared to $794,423 for the same period last year. Gross profit for the six months ended December 31, 2009 as a percentage of revenues decreased from 49.0% for the six months ended December 31, 2008 to 35.0% in the current year. The decrease in our gross profit percentage was due primarily to lower overall sales volume and less favorable product mix in the quarter ended December 31, 2009 compared to the same period last year. Our quarterly gross profit and gross profit percentage depend on a number of factors, including overall sales volume and mix of products sold among others and therefore vary from quarter to quarter.

Research and development expenses were $180,016 for the quarter ended December 31, 2009, compared to $139,070 for the same period last year, an increase of $40,946, or 29.4%. Research and development expenses were $194,663 for the six months ended December 31, 2009, compared to $315,680 for the same period last year, a decrease of $121,017, or 38.3%. The year-to-date decrease was due primarily to the implementation of certain cost containment plans beginning in fiscal year 2008 and 2009 including workforce reductions, and increased reimbursements from customers for product development activities. Research and development expenses depend on our assessment of new product opportunities and available resources. Research and development expenses were net of reimbursement of related costs of $29,244 and $79,826 during the quarters ended December 31, 2009 and 2008, respectively, and $193,627 and $168,856 during the six months ended December 31, 2009 and 2008, respectively. Based on customer orders received through December 31, 2009, we expect that reimbursements for research and development activities for the full fiscal year 2010 will exceed $0.5 million, which is nearly triple the amount in fiscal year 2009. We believe this increase in customer-sponsored R&D activity suggests that the new proprietary technologies we have developed during the last few years have enhanced our opportunities to develop and commercialize new and innovative products.

Selling, general and administrative expenses were $300,617 for the quarter ended December 31, 2009, compared to $387,982 for the same period last year, a decrease of $87,365, or 22.5%. Selling, general and administrative expenses were $613,303 for the six months ended December 31, 2009, compared to $759,931 for the same period last year, a decrease of $146,628 , or 19.3%. The decrease was due primarily to the implementation of certain cost containment plans beginning in fiscal year 2008 and 2009 including workforce reductions, as mentioned above.

Interest income was $168 for the quarter ended December 31, 2009, compared to $1,479 for the same period last year, a decrease of $1,311, or 88.6%. Interest income was $330 for the six months ended December 31, 2009, compared to $4,430 for the same period last year, a decrease of $4,100, or 92.6%.   The decrease was due to a lower base of cash and cash equivalents.

Interest expense was $64,875 for the quarter ended December 31, 2009, compared to $138,575 for the same period last year, a decrease of $73,700, or 53.2%. Interest expense was $129,750 for the six months ended December 31, 2009, compared to $324,050 for the same period last year, a decrease of $194,300, or 60.0%. The decrease was due to discontinuation of the amortization of debt discount related to the conversion feature of the 10% Senior Secured Convertible Notes issued on June 25, 2008. This portion of the debt discount became fully amortized during the second quarter of fiscal year 2009.

No income tax provision was recorded in the first half of fiscal year 2010 or 2009 because of the losses generated in those periods.

Liquidity and Capital Resources

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

We have traditionally funded working capital needs through product sales, management of working capital components of our business, and by cash received from public and private offerings of our common stock, warrants to purchase shares of our common stock and convertible notes. We have incurred quarter to quarter operating losses during our efforts to develop current products including endoscopes, image couplers, beamsplitters, thin film coatings, night vision and micro-optic lenses, prisms and assemblies for various applications and utilizing a number of proprietary and patent-pending technologies including Lenslock endoscope and micro-precision lens technologies. Our management expects that such operating losses will continue until sales increase to breakeven and profitable levels. Our management also believes that the opportunities represented by these products have the potential to generate sales increases to achieve breakeven and profitable results.

Our current financial condition may raise doubt among potential equity investors, customers and suppliers regarding our ability to continue as a going concern, as referenced by the Report of Independent Registered Public Accounting Firm on our financial statements for the year ended June 30, 2009. We may not be able to obtain working capital funds necessary in the time frame needed and at satisfactory terms to correct the going concern issue.

As of December 31, 2009, cash and cash equivalents were $216,560, accounts receivable were $483,983 and current liabilities were $1,775,732. We anticipate that deferred officers salaries and director consulting expenses accrued at December 31, 2009 will be settled by issuing restricted common stock rather than by cash payments. These deferred amounts included in current liabilities at December 31, 2009 total approximately $493,000. We believe that the introduction of several new products during the last four fiscal years, along with new and on-going customer relationships, will continue to generate additional revenues, which are required in order for us to achieve profitability. If these additional revenues are not achieved on a timely basis, we will be required and are prepared to implement further cost reduction measures and to seek additional funding, as necessary.

Contractual cash commitments for the fiscal years subsequent to December 31, 2009 are summarized as follows:

	2010	2011	Thereafter	Total
Operating Leases	$ 15,250	$ 800	$ 1,150	$ 17,200
Principal & Interest (1)	720,000			720,000
Totals	$ 735,250	$ 800	$ 1,150	$ 737,200

(1) This amount may be reduced to the extent the holders of the Senior Secured Convertible Notes elect to convert the principal on the Notes into our common stock.

We have contractual cash commitments related to open purchase orders for fiscal year 2010 of approximately $113,000.

In June 2008, we issued Senior Secured Convertible Notes and warrants, raising cash proceeds of $600,000.

Trends and Uncertainties That May Affect Future Results

Our fiscal year 2009 revenues were the highest in eight years. Our fiscal year 2009 revenues for the year ended June 30, 2009 increased 21.6% from the same period last year. Our revenues for the first quarter of fiscal 2010, however, decreased by 5.5% from the same period last year, and our revenues for the second quarter of fiscal year 2010 decreased by 28.6% from the same period last year.

We expect our pattern of quarter-to-quarter revenue fluctuations to continue, due to the introductory stage of many of our products and the unpredictable timing of orders from customers and the size of those orders in relation to total revenues. Contingent on available funding, we intend to continue to develop and commercialize new products and technical innovations, in particular:

- a new generation of endoscopes that incorporate Lenslock technology (patent pending);

- new components and instruments utilizing our new micro-precision lens technology (patent pending) for optical components and endoscopes under 1 mm;
- new custom medical products; and
- new night vision lenses.

If we do not have sufficient capital to develop and commercialize these products, our future revenues may decline because we cannot offer the innovative products the market is seeking. Over the past few years, we have implemented significant changes in new product and technology development by shifting the emphasis of research and development efforts from developing underlying technologies to commercialization of the applications of these new technologies. These have already been realized to some degree in a number of areas. Over the past two to three years our efforts have produced revenues from our new micro-precision lens products and new Lenslock endoscopes. Recent initiatives in the area of micro-precision lenses address specific customer opportunities in different medical specialty applications. In endoscope technologies, we continue new product offerings in our Lenslock product line. We have shipped over 650 ENT endoscopes with diameter of 2.7 mm that incorporate Lenslock technology. We recently completed prototypes of our 4 mm Lenslock sinuscope, and 5 mm Lenslock laproscope, and are actively pursuing development of our new 4 mm Lenslock wide field arthroscope. We believe that our Lenslock technology has advantages over competitive products due to ease of manufacture and repair, superior image quality, significant cost effectiveness and quality of repair. We anticipate that further incorporating this technology into our endoscope product line will lead to increased sales.

The principal and interest on the 10% Senior Secured Convertible Notes amounting to $600,000 and $120,000, respectively, are due June 25, 2010. This amount may be reduced to the extent the holders of the Notes elect to convert some or all of the principal on the Notes into our common stock. Should the holders not elect to convert all or a substantial amount of the balances due on the Notes into our common stock, it is highly unlikely that we will be able to generate enough cash from our operations to pay these balances in full on the specified due date. Therefore, we may renegotiate terms with existing holders or refinance this debt and, in either case, if available, the terms may be more burdensome. We are currently exploring the possibility of obtaining additional funding sources to satisfy this repayment obligation.

In the event the holders do not elect to convert all or a substantial amount of the balances due on the Notes into our common stock, or if we are not able to renegotiate the terms or obtain financing on terms satisfactory to us, or at all, we may ultimately be unable to meet our payment obligations under the Notes. In such event, all unpaid principal and interest will become immediately due and payable and the holders may pursue any other available remedies. The Notes are secured by a pledge of our assets pursuant to a pledge and security agreement and the security documents ancillary thereto, and in the event we are unable to meet our payment obligations, the holders would have the ability to require that we immediately pay all outstanding indebtedness, and we might not have sufficient assets to satisfy their demands. While we believe that this eventuality is unlikely, it is possible that in this event, we may be forced to seek protection under bankruptcy laws, which could harm our future operations and overall financial condition. Additionally, a debt default could significantly diminish the market value and marketability of our common stock.

During the last two quarters of 2008 and continuing through fiscal years 2009 and 2010, we implemented certain cost containment plans which included focusing on a limited number of products and technologies expected to provide near term revenues, streamlining operations, workforce reductions and deferring certain development initiatives. These measures reduced our overhead expenses.

Going forward, we intend to focus our development efforts on products we believe offer the best prospects to increase our near-term revenues. An example beyond the new instruments mentioned above includes the lenses we developed for a new color Night Vision system. During the quarter ended December 31, 2008, we shipped first article pre-production lens systems. These are for use in the new color Night Vision system and utilize an improved design that offers lower cost and lighter weight.

For the quarter ended December 31, 2009, our cash and cash equivalents decreased by $130,111 from the quarter ended September 30, 2009, compared to a decrease of $37,922 for the quarter ended September 30, 2009 from the quarter ended June 30, 2009. If our cash reserves continue to decrease, we will be required to seek additional funding for operations. The sale of additional equity or convertible debt securities would result in additional dilution to our stockholders, and debt financing, if available, may involve restrictive covenants that could restrict our operations or finances. Financing may not be available in amounts or on terms acceptable to us, if at all. If we cannot raise funds on acceptable terms or achieve positive cash flow, we may not be able to continue to conduct operations, develop new products, grow market share, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements, any of which would negatively impact our business, operating results and financial condition. If we are not successful in increasing our revenues, reducing our expenses or raising additional equity capital to generate sufficient cash flows to meet our obligations as they come due, we may not be able to continue as a going concern.

Beginning with our annual report on Form 10-K for the fiscal year ending June 30, 2010, we will need to comply with Section 404 of the Sarbanes-Oxley Act of 2002, which will require our independent registered public accounting firm to provide an attestation report regarding our internal controls over financial reporting. We expect our operating expense may increase as a result of the costs associated with the implementation of and maintaining compliance with Section 404.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

As a Smaller Reporting Company as defined by Rule 12b-2 of the Exchange Act and in Item 10(f)(1) of Regulation S-K, we are electing scaled disclosure reporting obligations and therefore are not required to provide the information requested by this Item.

Item 4T. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

Our Principal Executive Officer and our Principal Financial Officer evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this quarterly report on Form 10-Q. Based on this evaluation, our Principal Executive Officer and our Principal Financial Officer have concluded that our disclosure controls and procedures, including internal control over financial reporting, were not effective as of the quarterly period ended December 31, 2009, to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934, as amended (i) is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms, and (ii) is accumulated and communicated to our management, including our Principal Executive Officer and our Principal Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Our disclosure controls and procedures are intended to be designed to provide reasonable assurance that such information is accumulated and communicated to our management.

Our Principal Executive Officer and our Principal Financial Officer have concluded that our disclosure controls and procedures had the following deficiencies:

Segregation of Duties: As previously disclosed in our annual report on Form 10-K for the fiscal year ended June 30, 2008, our management identified a control deficiency during the 2008 fiscal year because we lacked sufficient staff to segregate accounting duties. We believe the control deficiency resulted primarily because we have the equivalent of one and one-half person performing all accounting-related on-site duties. As a result, we did not maintain adequate segregation of duties within our critical financial reporting applications, the related modules and financial reporting processes. This control deficiency could result in a misstatement of balance sheet and income statement accounts in our interim or annual consolidated financial statements that would not be detected. Accordingly, management has determined that this control deficiency constitutes a material weakness. No audit adjustments to our audited financial statements as of June 30, 2009 were necessary as a result of this condition.

To address and remediate the material weakness described above, beginning with the quarter ended September 30, 2008 and through the quarter ended December 31, 2009, we instituted a procedure whereby our President, our Executive Vice President and other members of our Board of Directors will perform a higher level review of the quarterly and annual reports on Form 10-Q and Form 10-K prior to filing.

We believe that the step outlined above strengthens our internal control over financial reporting and mitigates the material weakness described above. As part of our 2010 assessment of internal control over financial reporting, our management will evaluate this additional control to assess whether it is operating effectively.

Inventory Valuation: There are insufficient controls with respect to the valuation of our inventories. Specifically, the amounts used to value our inventory at June 30, 2009 with respect to overhead rates and purchased items were often not consistent with the supporting documentation, due to year-to-year changes in overhead rates and costs of purchased items that were not properly reflected in inventory valuation. Accordingly, management has determined that this control deficiency constitutes a material weakness. No audit adjustments to our audited financial statements as of June 30, 2009 were necessary as a result of this condition.

To address and remediate the material weakness described above, we have identified and begun to implement procedures to improve our inventory controls and documentation surrounding inventory valuation for overhead rates and purchased items.

We intend to continue to remediate material weaknesses and enhance our internal controls but cannot guarantee that our efforts will result in remediation of our material weaknesses or that new issues will not be exposed in this process.

Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting that occurred during the second quarter of our fiscal year covered by this quarterly report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

We may be involved from time to time in ordinary litigation, negotiation and settlement matters that will not have a material effect on our operations or finances. We are not aware of any pending or threatened litigation against us or our officers and directors in their capacity as such that could have a material impact on our operations or finances.

Item 1A. Risk Factors.

There have been no material changes from the risk factors as previously disclosed in our annual report on Form 10-K for the fiscal year ended June 30, 2009.

Items 2. Unregistered Sales of Equity Securities and Use of Proceeds.

We did not issue any unregistered securities during the quarter ended December 31, 2009.

Item 3. Defaults Upon Senior Securities.

As of December 31, 2009, we are not in default with respect to any indebtedness.

Item 4. Submission of Matters to a Vote of Security Holders.

We did not submit any matters to a vote of security holders during the quarter ended December 31, 2009.

Item 5. Other Information.

None.

Item 6. Exhibits.

Exhibit	Description
2.1	Asset Purchase Agreement between the Company and Optometrics Corporation, dated January 18, 2008 (included as Exhibit 2.1 to the Form 8-K filed January 25, 2008 and incorporated herein by reference).
3.1	Articles of Organization of the Company, as amended (included as Exhibit 3.1 to the Form SB-2 filed March 16, 2007 and incorporated herein by reference).
3.2	Bylaws of Precision Optics Corporation incorporated herein by reference to the Company s 1991 Annual Report on Form 10-KSB.
3.3	Articles of Amendment, dated December 11, 2008 (included as Exhibit 3.1 to the Form 8-K filed December 11, 2008 and incorporated herein by reference).
4.1	Registration Rights Agreement, dated March 17, 2000 (included as Exhibit 4.4 to the Form S-3 filed April 28, 2000 and incorporated herein by reference).
4.2	Registration Rights Agreement, dated June 30, 1998 (included as Exhibit 4.9 to the Form 10-KSB filed September 29, 1998 and incorporated herein by reference).
4.3	Registration Rights Agreement, dated August 5, 1999 (included as Exhibit 4.7 to the Form 10-KSB filed September 28, 1999 and incorporated herein by reference).
4.4	Registration Rights Agreement, dated February 1, 2007 (included as Exhibit 4.1 to the Form 8-K filed February 2, 2007 and incorporated herein by reference).
4.5	Form of Warrant to Purchase Shares of Common Stock (included as Exhibit 4.2 to the Form 8-K filed February 2, 2007 and incorporated herein by reference).
4.6	Registration Rights Agreement, dated June 25, 2008 (included as Exhibit 4.1 to the Form 8-K filed June 27, 2008 and incorporated herein by reference).

4.7	Form of Warrant, dated June 25, 2008 (included as Exhibit 4.2 to the Form 8-K filed June 27, 2008 and incorporated herein by reference).
4.8	Form of 10% Senior Secured Convertible Note, dated June 25, 2008 (included as Exhibit 4.3 to the Form 8-K filed June 27, 2008 and incorporated herein by reference).
10.1	Precision Optics Corporation, Inc. 1997 Incentive Plan, as amended and restated (included as Exhibit 10.1 to the Form 10-QSB filed November 13, 2003 and incorporated herein by reference).
10.2	Securities Purchase Agreement between the Company and investors, dated March 13, 2000 (included as Exhibit 2.1 to the Form S-3 filed April 28, 2000 and incorporated herein by reference).
10.3	Form of Securities Purchase Agreement between the Company and investors (included as Exhibit 10.1 to the Form 8-K filed April 19, 2006 and incorporated herein by reference).
10.4	Employment Offer Letter from the Company to Michael T. Pieniazek, dated September 15, 2006 (included as Exhibit 10.1 to the Form 8-K filed September 21, 2006 and incorporated herein by reference).
10.5	Precision Optics Corporation, Inc. 2006 Equity Incentive Plan (included as Exhibit 99.1 to the Form 8-K filed December 4, 2006 and incorporated herein by reference).
10.6	Purchase Agreement between the Company and investors, dated February 1, 2007 (included as Exhibit 10.1 to the Form 8-K filed February 2, 2007 and incorporated herein by reference).
10.7	Form of Incentive Stock Option Certificate (included as Exhibit 10.1 to the Form 10-QSB filed February 14, 2007 and incorporated herein by reference).
10.8	Form of Nonstatutory Stock Option Certificate (included as Exhibit 10.2 to the Form 10-QSB filed February 14, 2007 and incorporated herein by reference).
10.9	Purchase Agreement by and among the Company and each investor named therein, dated June 25, 2008 (included as Exhibit 10.1 to the Form 8-K filed June 27, 2008 and incorporated herein by reference).
10.10	Pledge and Security Agreement by and among the Company and each investor named therein, dated June 25, 2008 (included as Exhibit 10.2 to the Form 8-K filed June 27, 2008 and incorporated herein by reference).
10.11	Consulting Agreement between the Company and Jack P. Dreimiller, dated August 15, 2008 (included as Exhibit 10.1 to the Form 8-K filed August 18, 2008 and incorporated herein by reference).
10.12	Side Letter Agreement between the Company and the investors signatory to the Purchase Agreement, dated June 25, 2008, dated November 25, 2008 (included as Exhibit 10.1 to the Form 8-K filed December 11, 2008 and incorporated herein by reference).
10.13	Side Letter Agreement between the Company and the holders signatory to the 10% Senior Secured Convertible Note, dated December 11, 2008 (included as Exhibit 10.15 to the Form S-1 filed December 18, 2008 and incorporated herein by reference).
10.14	Side Letter Agreement between the Company and the holders signatory to the 10% Senior Secured Convertible Note, dated April 2, 2009 (included as Exhibit 10.16 to the Form S-1/A filed April 6, 2009 and incorporated herein by reference).
31.1	Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
31.2	Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).

32.1	Certification of Officers pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith).

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

	PRECISION OPTICS CORPORATION, INC.	
Date: February 16, 2010	By:	/s/ Richard E. Forkey Richard E. Forkey Chief Executive Officer (Principal Executive Officer)
Date: February 16, 2010	By:	/s/ Jack P. Dreimiller Jack P. Dreimiller Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)