PRECISION OPTICS CORPORATION INC
Form 10QSB
November 14, 2005

FORM 10-QSB

U.S. SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

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

For the quarterly period ended September 30, 2005

Commission file number ______ 001-10647________

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 (I.R.S. Employer Identification No.)

22 East Broadway, Gardner, Massachusetts 01440-3338
(Address of principal executive offices) (Zip Code)

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

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

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 issuer's common stock, par value $.01 per share, at October 31, 2005 was 7,008,212 shares.

Transitional Small Business Disclosure Format (check one):

Yes o No x

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

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Item 1

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

ASSETS

		September 30, 2005		June 30, 2005
CURRENT ASSETS				
Cash and Cash Equivalents	$	1,632,318	$	2,171,693
Accounts Receivable, net		210,602		177,031
Inventories, net		597,847		599,619
Prepaid Expenses		95,898		62,422
Total Current Assets		2,536,665		3,010,765
PROPERTY AND EQUIPMENT				
Machinery and Equipment		3,490,022		3,539,205
Leasehold Improvements		553,595		553,596
Furniture and Fixtures		96,831		96,831
Vehicles		42,343		42,343
Less: Accumulated Depreciation		(4,079,887)		(4,092,202)
Net Property and Equipment		102,904		139,773
OTHER ASSETS				
Cash surrender value of life insurance policies		16,440		16,440
Patents, net		206,059		201,627
Total Other Assets		222,499		218,067
TOTAL ASSETS	$	2,862,068	$	3,368,605

LIABILITIES AND STOCKHOLDERS' EQUITY

		September 30, 2005		June 30, 2005
CURRENT LIABILITIES				
Accounts Payable	$	235,696		160,593
Customer Advances		-		18,000
Accrued Employee Compensation		171,870		208,851
Accrued Professional Services		100,594		74,000
Other Accrued Liabilities		64,184		57,566
Total Current Liabilities		572,344		519,010
STOCKHOLDERS' EQUITY				
Common Stock, $.01 par value-				
Authorized -- 20,000,000 shares				
Issued and Outstanding - 7,008,212 shares				
at September 30, 2005 and at June 30, 2005		70,082		70,082
Additional Paid-in Capital		32,751,597		32,751,597
Accumulated Deficit		(30,531,955)		(29,972,084)
Total Stockholders' Equity		2,289,724		2,849,595
TOTAL LIABILITIES AND				
STOCKHOLDERS' EQUITY	$	2,862,068	$	3,368,605

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE THREE MONTHS ENDED
SEPTEMBER 30, 2005 AND SEPTEMBER 30, 2004
(UNAUDITED)

	Three Months Ended September 30, 2005		2004	
REVENUES	$	419,582	$	263,810
COST OF GOODS SOLD		521,501		356,015
Gross Loss		(101,919)		(92,205)
RESEARCH and DEVELOPMENT EXPENSES		208,111		356,406
SELLING, GENERAL and ADMINISTRATIVE EXPENSES		424,688		497,439
GAIN ON SALE OF ASSETS		(165,700)		-
Total Operating Expenses		467,099		853,845
Operating Loss		(569,018)		(946,050)
INTEREST INCOME		9,147		12,592
Net Loss	$	(559,871)	$	(933,458)
Basic and Diluted Loss Per Share	$	(0.08)	$	(0.16)
Weighted Average Common Shares Outstanding - Basic and Diluted		7,008,212		5,979,832

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2005 AND 2004 (UNAUDITED)

	Three Months Ended September 30, 2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net Loss	$ (559,871)	$ (933,458)
Adjustments to Reconcile Net Loss to Net Cash		
Used In Operating Activities -		
Depreciation and Amortization	41,382	49,665
Gain on Disposal of Asset	(165,700)	-
Provision for Inventory Write-Down	-	57,300
Changes in Operating Assets and Liabilities-		
Accounts Receivable,	(33,571)	(25,929)
Inventories	1,772	44,236
Prepaid Expenses	(33,476)	(44,622)
Accounts Payable	75,103	131,269
Other Accrued Expenses	(3,769)	(32,953)
Net Cash Used In Operating Activities	(678,130)	(754,492)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of Property and Equipment	(8,017)	(1,312)
Proceeds from Disposal of Asset, net	162,000	-
Increase in Other Assets	(15,229)	(5,724)
Net Cash Provided By (Used In) Investing Activities	138,755	(7,036)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Gross Proceeds from Rights Offering	-	5,256,159
Payment of Deferred Financing Costs	-	(104,417)
Net Cash Provided By Financing Activities	-	5,151,742
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(539,375)	4,390,214
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	2,171,693	343,260
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 1,632,318	$ 4,733,474
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash Paid for-		
Interest	$ -	$ -
Income Taxes	$ 912	$ 912

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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.

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 first quarter of the Company's fiscal year 2006. 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, 2005 together with the Report of Independent Registered Public Accounting Firm filed under cover of the Company's 2005 Annual Report on Form 10-KSB.

The Company has incurred significant operating losses during the last nine fiscal years. This trend was primarily the result of the loss of several significant customers, completion of several large nonrecurring government contracts, and operating losses and provision for asset impairment, restructuring, and inventory write-downs associated with the downturn in demand for optical filters used in telecommunications systems. In July 2004, the Company completed a rights offering to stockholders of record at June 7, 2004 by issuing 5,256,159 shares of common stock. Net cash proceeds to the Company (after offering costs of $222,175) were $5,033,984.

In the past four fiscal years, the Company has implemented a number of restructuring and cost saving measures in an effort to align costs with revenues and strengthen financial performance. Most recently, savings were achieved through reduced professional fees, workforce reduction of one full-time employee and changing the CFO role to part-time, and through reduced premiums of the Company’s general insurance. In addition, the Company will continue its review of other expense areas to determine where additional reductions in discretionary spending can be achieved.

The Company’s current sources of liquidity consist of its cash and cash equivalents and accounts receivable. At September 30, 2005 the Company had $1,632,318 in cash and cash equivalents and $210,602 in accounts receivable.

The Company expects its recent pattern of quarter-to-quarter revenue fluctuations to continue, due to the uncertain timing of individual orders and their size in relation to total revenues. The Company remains confident in the value of its technology and expertise both in medical and surgical applications and elsewhere. In addition, despite strict controls on R&D spending, the Company continues developing new products and researching technical innovations.

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 believes, based on its operating and strategic plans, that it will have sufficient funds to conduct operations through at least the next twelve months.

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 months ended September 30, 2005 and 2004, 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 1,316,783 and 217,914 for the three months ended September 30, 2005 and 2004, respectively.

Revenue Recognition

In December 2003, the Securities and Exchange Commission issued Staff Accounting Bulletin (“SAB”) No. 104 which establishes guidance in applying generally accepted accounting principles to revenue recognition in financial statements and was effective for the Company’s fiscal year 2004. SAB No. 104 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services rendered; (3) the price to the buyer is fixed and determinable; and (4) collectibility is reasonably assured. The Company’s shipping terms are customarily FOB shipping point. The Company’s revenue recognition practices comply with the guidance in the bulletin.

Sales price of products and services sold is fixed and determinable after receipt and acceptance of a customer’s purchase order or properly executed sales contract, typically before any work is performed. Management reviews each customer purchase order or sales contract to determine that the work to be performed is specified and there are no unusual terms and conditions which would raise questions as to whether the sales price is fixed or determinable. The Company assesses credit worthiness of customers based upon prior history with the customer and assessment of financial condition. Accounts receivable are stated at the amount management expects to collect from outstanding balances. An allowance for doubtful accounts is provided for that portion of accounts receivable considered to be uncollectible, based upon historical experience and management’s evaluation of outstanding accounts receivable at the end of the year. Bad debts are written off against the allowance when identified.

The Company's revenue transactions typically do not contain multiple deliverable elements for future performance obligations to customers, other than a standard one-year warranty on materials and workmanship, the estimated costs for which are provided for at the time revenue is recognized.

Revenues for industrial and medical products sold in the normal course of business are recognized upon shipment when delivery terms are FOB shipping point and all other revenue recognition criteria have been met. Services that the Company provides to customers consist of repairs and engineering design and development. Recognition of service revenue occurs (assuming all other revenue recognition criteria have been met) upon delivery to the customer of the repaired product. Contract revenues, where the period of performance extends beyond six months, including revenues from customer-sponsored research and development contracts, are recognized under the percentage-of-completion method. The percentage of completion is determined by computing the percentage of the actual cost of work performed to the anticipated total contract costs, or on the basis of units shipped. When the estimate of a contract indicates a loss, the Company's policy is to record the entire estimated loss in the current period. Gross shipping charges reimbursable from customers, to deliver product, are insignificant and are included in Revenues, while shipping costs are shown in Selling, General and Administrative Expenses section of the Consolidated Statement of Operations.

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.

Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123R, *Share-Based Payment* (SFAS 123R), an amendment of FASB Statements No. 123 and No. 95, *Statement of Cash Flows*, which requires companies to measure and recognize compensation expense for all stock-based payments at fair value. Pro forma disclosure will no longer be an alternative. SFAS 123R is effective for the first annual period beginning after December 15, 2005 and thus, will be effective for the Company beginning with the first quarter of fiscal year 2007 (July 1, 2006). Under SFAS 123R, the Company must determine the appropriate fair value model to be used for valuing share-based payments, the amortization for compensation cost and the transition method to be used at the date of adoption. The transition alternatives include retrospective and prospective adoption methods. Under the retrospective method, prior periods may be restated based on the amounts previously recognized under SFAS 123 for purposes of pro forma disclosures either for all periods presented or as of the beginning for the year of adoption.

The prospective method requires that compensation expense be recognized beginning with the effective date, based on the requirements of SFAS 123R, for all share-based payments granted after the effective date, and based on the requirements of SFAS 123, for all awards granted to employees prior to the effective date of SFAS 123R that remain unvested on the effective date.

The Company is evaluating the requirements of SFAS 123R and has not determined its method of adoption or the impact on its financial position or the results of operations. See Note 3 for information related to the pro forma effects on the Company's reported net loss and net loss per share of applying the fair value recognition provisions of the previous SFAS 123 to stock-based employee compensation.

2. INVENTORIES

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

	September 30, 2005	June 30, 2005
Raw Materials	$ 205,828	$ 181,548
Work-In-Progress	181,034	185,047
Finished Goods	210,985	233,024
Total Inventories	$ 597,847	$ 599,619

3. STOCK-BASED COMPENSATION

The Company accounts for its stock-based compensation using the intrinsic value method provided for under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* and related interpretations. Under APB No. 25 and related interpretations, compensation cost is recognized based on the difference, if any, on the date of grant between the fair value of the Company’s stock and the amount an employee must pay to acquire the stock. Statement of Financial Accounting Standards (“SFAS”) No. 123, *Accounting for Stock-Based Compensation*, (as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*), establishes a fair-value-based method of accounting for stock-based compensation plans. The Company has adopted the disclosure-only alternative under SFAS No. 123, which requires the disclosure of the pro forma effects on net loss and net loss per share as if the fair value accounting prescribed by SFAS No. 123 had been adopted.

No stock-based employee compensation cost is reflected in net loss, as all options granted had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net loss and net loss per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation:

	3 Months Ended September 30			
		2005		**2004**
Net loss, as reported	$	(559,871)	$	(933,458)
Add: Total stock-based employee compensation expense determined under fair value based method for all awards		(107,272)		(9,212)
Pro forma net loss	$	(667,143)	$	(942,670)
Net loss per share:				
As reported - basic and diluted		(.08)		(.16)
Pro forma - basic and diluted	$	(.10)	$	(.16)

The Company has computed the pro forma disclosures required under SFAS No. 123 for fiscal 2005 and 2004 using the Black-Scholes option pricing model prescribed by SFAS No. 123 (See Note 1).

The assumptions used for the three months ended September 30, 2005 are as follows:

		2005
Risk-free interest rates		3.84%
Expected dividend yield		-
Expected lives		5.3 years
Expected volatility		107%
Weighted average fair value of grants	$	0.60

No options were granted in the three months ended September 30, 2004.

On June 13, 2005 the Company issued options to purchase 934,000 shares of common stock at an exercise price of $0.83 per share. At the date of issuance, 30% of the options vested immediately, and the vesting of the remaining options is subject to achievement of certain financial milestones by the Company. According to Accounting Principles Board Opinion No. 25, "*Accounting for Stock Issued to Employees*," the options described above are subject to variable accounting until the awards are exercised, forfeited, or expire unexercised, which includes periodic measurement of compensation expense based on the intrinsic value of the options. The compensation cost will be recognized and adjusted quarterly for vested options or ratably over the vesting period for unvested options. No compensation expense related to these stock options is reflected in the net loss for the quarter ended September 30, 2005 as all options granted had an exercise price greater than the market value of the underlying common stock as of September 30, 2005. As long as the options remain outstanding, the compensation adjustment remains subject to ongoing quarterly adjustments based on changes in the market price of the Company's common stock.

4. Sale of Equipment

In June 2005 the Company received an $18,000 deposit towards the sale of equipment previously used in its discontinued telecommunications business and in July 2005 recognized the sale of this equipment for $180,000, resulting in a gain of $165,700 in the quarter ending September 30, 2005.

Item 2

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, 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 regain and maintain compliance with requirements for continued listing on the Nasdaq Capital Market; the Company’s ability to attract and retain personnel with the necessary scientific and technical skills, the timing and completion of significant orders; the timing and amount of the Company’s research and development expenditures; the timing and level of market acceptance of customers’ products for which the Company supplies components; performance of the Company’s vendors; the ability of the Company to control costs associated with performance under fixed price contracts; and the continued availability to the Company of essential supplies, materials and services; which are described further below under “Factors that May Affect Future Results and Market Price of Stock.” 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.

Overview

Precision Optics Corporation, a developer and manufacturer of advanced optical instruments since 1982, designs and produces high-quality optical thin film coatings, medical instruments, and other advanced optical systems including micro-optics with dimensions as small as 200 microns. The Company’s 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.

The Company continues to develop its new line of endoscopes based on unique, patent pending lenslock™ technology. This has resulted in the recent completion of a number of prototype instruments. The Company has received first production orders for these newly redesigned scopes and is now initiating discussions with leading companies in the endoscopy market.

The Company is now manufacturing ultra-small lenses, prisms, and assemblies with sizes ranging from 0.2 mm to 1 mm, for a number of customers. The Company is also in discussions with several customers regarding manufacturing of prototypes of similar products. These optical components and instruments utilize a variety of innovative techniques including the Company’s patent-pending micro-precision™ lens technology.

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The Company recently completed a partnership effort for the proprietary development of a new class of night vision lenses including a new patent-pending eyepiece lens. With prototypes completed, the product incorporating the Company's new night vision lenses is currently being evaluated for need and use, including field testing. The Company is also exploring new initiatives in single-molecule technology and nanotechnology for biomedical and other applications.

The Company is currently developing specialty instruments incorporating its patent-pending LENSLOCK™ technology which ensures lower cost, easier repairability and enhanced durability. The Company is also aggressively pursuing ultra-small instruments (some with lenses less than one millimeter in diameter) utilizing patent-pending micro-precision™ lens technology. The Company is also exploring new initiatives in single-molecule technology and nanotechnology for biomedical and other applications.

Precision Optics Corporation is certified to the ISO 9001 Quality Standard, and complies with the FDA Good Manufacturing Practices and the European Union Medical Device Directive for CE Marking of its medical products. The Company's Internet Website is www.poci.com.

The areas in which the Company does business are highly competitive and include both foreign and domestic competitors. Many of the Company's competitors are larger and have substantially greater resources than the Company. Furthermore, other domestic or foreign companies, some with greater experience in the optics industry and greater financial resources than the Company, may seek to produce products or services that compete with those of the Company. The Company uses third party production facilities overseas to produce key components for the Company's business, such as lenses. The Company believes that the cost savings from such production is essential to the Company's ability to compete on a price basis in the medical products area particularly and to the Company's profitability generally.

The Company believes that competition for sales of its medical products, which have been principally sold to original equipment manufacturer (OEM) customers, is based on performance and other technical features, as well as other factors, such as scheduling and reliability, in addition to competitive price.

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

The Company relies, in part, upon patents, trade secrets and proprietary knowledge as well as personnel policies and employee confidentiality agreements concerning inventions and other creative efforts to develop and to maintain its competitive position. The Company does not believe that its business is dependent upon any particular patent, patent pending, or license, although it believes that trade secrets and confidential know-how may be important to the Company's scientific and commercial success.

The Company conducts its domestic operations at two leased facilities in Gardner, Massachusetts. The Company rents office space in Hong Kong for sales, marketing and supplier quality control and liaison activities of its Hong Kong subsidiary. The Company believes these facilities are adequate for its current operations. Significant increases in production or the addition of significant equipment or manufacturing capabilities in connection with the production for the Company's line of endoscopes, optical thin films, and other products may, however, require the acquisition or lease of additional facilities.

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 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.

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

In December 2003, the Securities and Exchange Commission issued Staff Accounting Bulletin ("SAB") No. 104 which establishes guidance in applying generally accepted accounting principles to revenue recognition in financial statements and was effective for the Company's fiscal year 2004. SAB No. 104 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services rendered; (3) the price to the buyer is fixed and determinable; and (4) collectibility is reasonably assured. The Company's shipping terms are customarily FOB shipping point. The Company's revenue recognition practices comply with the guidance in the bulletin.

Sales price of products and services sold is fixed and determinable after receipt and acceptance of a customer's purchase order or properly executed sales contract, typically before any work is performed. Management reviews each customer purchase order or sales contract to determine that the work to be performed is specified and there are no unusual terms and conditions which would raise questions as to whether the sales price is fixed or determinable. The Company assesses credit worthiness of customers based upon prior history with the customer and assessment of financial condition. Accounts receivable are stated at the amount management expects to collect from outstanding balances. An allowance for doubtful accounts is provided for that portion of accounts receivable considered to be uncollectible, based upon historical experience and management's evaluation of outstanding accounts receivable at the end of the year. Bad debts are written off against the allowance when identified.

The Company's revenue transactions typically do not contain multiple deliverable elements for future performance obligations to customers, other than a standard one-year warranty on materials and workmanship, the estimated costs for which are provided for at the time revenue is recognized.

Revenues for industrial and medical products sold in the normal course of business are recognized upon shipment when delivery terms are FOB shipping point and all other revenue recognition criteria have been met. Services that the Company provides to customers consist of repairs and engineering design and development. Recognition of service revenue occurs (assuming all other revenue recognition criteria have been met) upon delivery to the customer of the repaired product. Contract revenues, where the period of performance extends beyond six months, including revenues from customer-sponsored research and development contracts, are recognized under the percentage-of-completion method. The percentage of completion is determined by computing the percentage of the actual cost of work performed to the anticipated total contract costs, or on the basis of units shipped. When the estimate of a contract indicates a loss, the Company’s policy is to record the entire estimated loss in the current period. Gross shipping charges reimbursable from customers, to deliver product, is insignificant and included in Revenues, while shipping costs are shown in Selling, General and Administrative Expenses section of the Consolidated Statement of Operations.

Inventories

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

Impairment of Long-Lived Assets and Long-Lived Assets to be Disposed of

The Company accounts for impairment of long-lived assets in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived* Assets. This statement requires that long-lived assets and certain identifiable intangibles be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to undiscounted future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of through sale 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.

Stock-Based Compensation

The Company accounts for its stock-based compensation using the intrinsic value method provided for under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* and related interpretations. Under APB No. 25 and related interpretations, compensation cost is recognized based on the difference, if any, on the date of grant between the fair value of the Company’s stock and the amount an employee must pay to acquire the stock. Statement of Financial Accounting Standards (“SFAS”) No. 123, Accounting for Stock-Based Compensation, (as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*), establishes a fair-value-based method of accounting for stock-based compensation plans. The Company has adopted the disclosure-only alternative under SFAS No. 123, which requires the disclosure of the pro forma effects on net loss and net loss per share as if the fair value accounting prescribed by SFAS No. 123 had been adopted.

Results of Operations

Total revenues for the quarter ended September 30, 2005 (the first quarter of fiscal year 2006) increased by approximately $156,000 or 59.0% from the same period in the prior year.
The increase was due primarily to higher sales of medical products (up by approximately $70,000, or 29%), and higher sales of non-medical products (up by approximately $84,000, or 463%). Sales of medical products were higher due primarily to higher sales of micro-lenses, autoclavable endoscopes and autoclavable couplers. Non-medical product sales were higher due primarily to higher sales of industrial filters and non-medical camera couplers.

Revenues from the Company’s largest customers, as a percentage of total revenues for the three months ended September 30, 2005 and 2004, were as follows:

	2005	**2004**
Customer A	15	37
Customer B	15	11
Customer C	-	-
All Others	70	52
	100%	100%

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

At September 30, 2005, receivables from the Company’s two largest customers were approximately 19% and 15%, respectively, of the total net accounts receivable. At June 30, 2005, receivables from the Company’s largest customers were approximately 19%, 16%, and 10%, respectively of the total net accounts receivable. No other customer accounted for more than 10% of the Company’s receivables as of September 30, 2005 and June 30, 2005.

Gross profit/(loss) for the quarter ended September 30, 2005 as a percentage of revenues decreased from a negative 35.0% for the quarter ended September 30, 2004 to a negative 24.3% in the current quarter. The favorable change in gross profit was due primarily to higher sales volume.

Research and development expenses decreased by approximately $148,000, or 41.6%, for the quarter ended September 30, 2005, compared to the same period last year. Quarterly research and development expenses depend on the Company's assessment of new product opportunities.

Selling, general and administrative expenses decreased by approximately $73,000, or 14.6% for the quarter ended September 30, 2005 compared to the same period last year. Savings were achieved through reduced professional fees, changing the CFO role to part-time, and through reduced premiums from changing the Company's general insurance provider.

Interest income decreased by approximately $3,400, or 27.4% for the quarter ended September 30, 2005 compared to the previous year. The decrease was due to the lower base of cash and cash equivalents.

No income tax provision was recorded in the first quarter of fiscal year 2006 or 2005 because of the losses generated in those periods.

Liquidity and Capital Resources

For the three months ended September 30, 2005, the Company's cash and cash equivalents decreased by $539,375 to $1,632,318. The decrease in cash was due primarily from cash used in operating activities of $678,130, capital expenditures of $8,017, and patent costs of $15,229. The decrease in cash was partially offset by proceeds of $162,000 received from the sale of equipment previously used in its discontinued telecommunication business.

The Company believes, based on its operating and strategic plans and the cash held by the Company, that it will have sufficient funds to conduct operations through at least the next twelve months. We will likely need to raise additional capital in the near term to fund our operations, in particular, to support our ongoing product development activities. We may seek funding through additional public or private equity offerings, debt or other strategic financings or agreements with customers or vendors. Additional financing may not be available to us when needed, or, if available, may not be available on favorable terms. If we cannot obtain adequate financing on acceptable terms when such financing is required, our business will be adversely affected.

Contractual cash commitments for the fiscal years subsequent to September 30, 2005 are summarized as follows:

	2006	2007	Thereafter	Total
Operating leases	$ 18,088	$ 741	$ 1,111	$ 19,940

The Company provides a standard one-year warranty on materials and workmanship to its customers. The Company provides for estimated warranty costs at the time product revenue is recognized. Warranty costs are included as a component of cost of goods sold in the accompanying consolidated statements of operations. For the three month periods ended September 30, 2005 and 2004, warranty costs were not significant.

Trends and Uncertainties That May Affect Future Results

For the quarter ended September 30, 2005, the Company's cash and cash equivalents decreased by $539,375, compared to $866,229 for the previous quarter ended June 30, 2005. The decrease in cash usage is attributable primarily to higher cash collections in the quarter ended September 30, 2005, resulting from higher sales in that quarter, and the timing of cash receipts from customers, and the receipt of $162,000 from the sale of equipment previously used in its discontinued telecommunication business.

Capital equipment expenditures during the quarter ended September 30, 2005 were $8,017, up from approximately $1,000 from the same period in 2004. Future capital expenditures will depend on future sales and the success of ongoing research and development efforts.

For the quarter ended September 30, 2005, research and development expenses were $208,111 down 42% from $356,406 a year earlier. The level of future quarterly R&D expenses will ultimately depend on the Company's assessment of new product opportunities and available cash resources.

The Company expects its recent pattern of quarter-to-quarter revenue fluctuations to continue, due to the uncertain timing or orders from customers and their size in relation to total revenues. The Company continues to move forward with new products and technical innovations, in particular, the development of a new generation (patent pending) of its world-class product line of 3-D endoscopes, the extension of lenslock™ technology (patent pending) to its entire line of endoscopes, and new instruments utilizing the Company's micro-precisionTM lens technology (patent pending) for endoscopes under 1 mm. The Company continues to explore potential applications of single-molecule technology and nanotechnology.

The Company believes that the recent introduction of several new products, along with new and ongoing 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.

Item 3 Controls and Procedures

(a) As of the end of the period covered by this quarterly report, the Company's Chief Executive Officer and Principal Financial Officer have conducted an evaluation of the Company's disclosure controls and procedures. Based on their evaluation, the Company's Chief Executive Officer and Principal 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) There was no change in the Company's internal control over financial reporting during the Company's most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Items 1-5 Not Applicable.

Item 6 Exhibits

Exhibit 31.1 - Certifications of the Company's Chief Executive Officer required by Rule 13a-14(a)/15d-14(a)

Exhibit 31.2 - Certification of the Company's Chief Financial Officer required by Rule 13a-14(a)/15d-14(a)

Exhibit 32.1 - Certifications of the Company's Chief Executive Officer and Chief Financial Officer required by Rule 13a-14(b) and 18 U.S. C. 1350.

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

PRECISION OPTICS CORPORATION, INC.

DATE: November 14, 2005

BY: /s/ R. MICHAEL ARBON

R. Michael Arbon
Chief Financial Officer and Clerk

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