PRECISION OPTICS CORPORATION INC
Form 10KSB
September 17, 2004

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-KSB

(Mark One)

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

For the Fiscal Year Ended June 30, 2004

OR

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

For transition period from ____ to ____

Commission File Number 001-10647

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

MASSACHUSETTS	**04-279-5294**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

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

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

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

None

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

Common Stock, $.01 par value

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

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

X

The issuer□s revenues for its most recent fiscal year were $1,464,964.

The aggregate market value of the voting stock, consisting solely of common stock, held by non-affiliates of the issuer computed by reference to the closing price of such stock was $3,325,138 as of August 31, 2004.

The number of shares of outstanding common stock of the issuer as of August 31, 2004 was 7,008,212.

DOCUMENTS INCORPORATED BY REFERENCE

The issuer□s Proxy Statement for the 2004 Annual Meeting of Shareholders to be held on November 9, 2004 is incorporated into Part III of this Form 10-KSB.

PART I

ITEM 1. DESCRIPTION OF BUSINESS

BUSINESS DEVELOPMENT

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

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

BUSINESS OF ISSUER

Precision Optics Corporation, a developer and manufacturer of advanced optical instruments since 1982, designs and produces high-quality medical instruments, optical thin film coatings, and other advanced optical systems. The Companys medical instrumentation line includes laparoscopes, arthroscopes and endocouplers and a line of world-class 3-D endoscopes for use in minimally invasive surgical procedures. 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 Companys Internet Website is www.poci.com.

Principal Products and Services and Methods of Distribution.

Medical Products. The Companys medical products include endoscopes, as well as image couplers, beamsplitters and adapters, all of which are used as accessories to endoscopes.

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

In March 2002, the Company shipped the first production lot of autoclavable endoscopes to a major orthopedic equipment supplier. These endoscopes, which are also CE Mark certified for European use, have been designed and tested to withstand sterilization by flash and standard autoclave, as well as all other commonly used medical sterilization means. The major benefits of autoclavable instruments include increased patient safety, quick turnaround, and elimination of hazardous sterilant and by-product materials, all of which provide a much better value to the user. The Company believes its autoclavable endoscope technology will generate opportunities for endoscope revenue growth, particularly in Europe where autoclaving is the preferred method of sterilization.

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

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

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

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

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

Competition and Markets.

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

The Company believes that competition for sales of its medical products and services, which have been principally sold to medical device companies, who incorporate the Company's products into their systems, 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 has marketed and sold its endoscopes to original equipment manufacturer (OEM) video camera and video endoscopy suppliers for resale under the purchaser's name. A number of domestic and foreign competitors also sell endoscopes to such OEM suppliers, and the Company's share of the endoscope market is nominal. The Company believes that, while its resources are substantially more limited than its competitors, the Company can compete successfully in this market on the basis of price and delivery.

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

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

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

Research and Development.

The Company believes that its future success depends to a large degree on its ability to continue to conceive and to develop new optical products and services to enhance the performance characteristics and methods of manufacture of existing products. Accordingly, it expects to continue to seek to obtain product-related design and development contracts with customers and to invest its own funds on its research and development. The Company spent approximately $1,319,000 and $1,235,000 of its own funds during fiscal years 2004 and 2003, respectively, on research and development.

The Company continues to explore potential applications of single-molecule technology and nanotechnology.

Raw Materials and Principal Suppliers.

For all of the Company's products, except for thin film coatings, the basic raw material is precision grade optical glass, which the Company obtains from several major suppliers. Outside vendors grind and polish most of the Company's lenses and prisms. For optical thin film coatings, the basic raw materials are metals and dielectric compounds, which the Company obtains from a variety of chemical suppliers. Certain of the thin film coatings utilized in the Company's products are currently procured from an outside supplier, but most thin film coatings are produced in-house. The Company believes that its demand for these raw materials and thin film coating services is small relative to the total supply and that materials and services required for the production of its products are currently available in sufficient production quantities and will be available for fiscal year 2005. The Company believes, however, that there are relatively few s uppliers of the high quality lenses and prisms which its endoscopes require. The Company has therefore established an in-house optical shop for producing ultra-high quality prisms, micro-optics and other specialized optics for a variety of medical and industrial applications.

Patents and Trademarks.

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

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

<u>Employees</u>.

As of June 30, 2004, the Company had 30 full-time employees and 5 part-time employees. There were 17 employees in manufacturing, 11 in engineering, 2 in sales and marketing, and 5 in finance and administration.

<u>Customers</u>.

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

	2004	2003	2002
Customer A	24%	17%	18%
Customer B	22	2	—
Customer C	—	44	—
Customer D	4	5	23
All Others	50	32	59
	100%	100%	100%

No other customer accounted for more than 10% of the Company’s revenues in fiscal years 2004, 2003, and 2002.

<u>Environmental Protection and the Effect of Existing or Probable Government Regulations on the Business</u>.

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

<u>Need for Government Approval of Principal Products or Services and Effect of Existing or Probable Government Regulations on the Business</u>.

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

ITEM 2. DESCRIPTION OF PROPERTY

The Company conducts its domestic operations at two facilities in Gardner, Massachusetts. The main Gardner facility is leased from a corporation owned by an officer-shareholder-director of the Company. The lease terminated in December 1999 and the Company is currently a tenant at will. The other Gardner facility is being rented on a month-to-month basis. 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 and adequately covered by insurance. Significant increases in production or the addition of significant equipment additions or manufacturing capabilities in connection with the production of the Company’s line of endoscopes, optical thin films, and other products may, however, require the acquisition or lease of additional facilities. The Company may establish production facilities domestically or overseas to produce key assemblies or components, such as lenses, for the Company’s products. Overseas facilities may subject the Company to the political and economic risks associated with overseas operations. The loss of or inability to establish or maintain such additional domestic or overseas facilities could materially adversely affect the Company’s competitive position and profitability.

ITEM 3. LEGAL PROCEEDINGS

None.

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

No matters were submitted to a vote of the Company’s security holders during the fourth quarter of fiscal year 2004.

Directors and Executive Officers of the Company

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

Name	Position with the Company or Principal Occupation
Richard E. Forkey	Chairman of the Board, Chief Executive Officer, President, Treasurer and Director
Jack P. Dreimiller	Senior Vice President, Finance, Chief Financial Officer and Clerk
Edward A. Benjamin	Director and Member of Audit Committee. Mr. Benjamin is a retired partner in the law firm of Ropes & Gray LLP, Boston, Massachusetts.
Joel R. Pitlor	Director. Mr. Pitlor is president of J.R. Pitlor, a management consulting firm based in Cambridge, Massachusetts.
Robert R. Shannon	Director and Member of Audit Committee. Mr. Shannon is a professor at the Optical Sciences Center of the University of Arizona in Tucson, Arizona.

PART II

ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

The Company's common stock is listed on the National Association of Securities Dealers Automated Quotation (NASDAQ) System under the symbol "POCI." Since January 1992, the NASDAQ SmallCap Market has been the principal market in which the Company's stock is publicly traded. The high and low sales prices (as adjusted for the 1-for-6 reverse stock split that became effective on January 29, 2003) for the Company's stock for each full quarterly period within the two most recent fiscal years were as follows as reported by NASDAQ.

	2003		2004	
Quarter	High	Low	High	Low
First	$3.42	$ 1.32	$2.80	$1.90
Second	$4.56	$ .96	$2.67	$1.71
Third	$2.40	$ 1.30	$6.99	$1.96
Fourth	$3.44	$ 1.43	$5.72	$1.05

As of August 31, 2004, there were approximately 203 holders of record of the Company's common stock. Holders of record include nominees who may hold shares on behalf of multiple beneficial owners.

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

EQUITY COMPENSATION PLAN INFORMATION

The following table provides information about the Company's Common Stock that may be issued upon the exercise of options, warrants and rights under all of our existing equity compensation plans as of June 30, 2004, including, but not limited to, the 1989 Stock Option Plan and the 1997 Incentive Plan:

	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in first column)
Equity compensation plans approved by shareholders	131,953	$11.79	183,153(1)
Equity compensation plans not approved by shareholders	9,168(2)(3)(4)	$8.08	n/a
Total	141,121	$11.55	183,153

(1) Includes 183,153 shares of Common Stock available for future grants under the Company’s 1997 Incentive Plan. No shares are available for future grants under the Company’s 1989 Stock Option Plan.

(2) Includes 2,500 shares of Common Stock issuable upon exercise of outstanding options granted to Mr. Benjamin in connection with his service on the Board of Directors. These options may be exercised at a price of $8.25 per share and expire on December 15, 2004.

(3) Includes 2,500 shares of Common Stock issuable upon exercise of outstanding options granted to Mr. Shannon in connection with his service on the Board of Directors. These options may be exercised at a price of $8.25 per share and expire on December 15, 2004.

(4) Includes 4,168 shares of Common Stock issuable upon exercise of outstanding options granted to Werner Thiel in connection with his service as a consultant to the Company. Options exercisable for 3,334 shares may be exercised at a price of $7.78125 and expire on July 13, 2005. Options exercisable for 834 shares may be exercised at a price of $8.25 and expire on December 15, 2004.

ITEM 6. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Important Factors Regarding Forward-Looking Statements

When used in this discussion, the words “believes”, “anticipates”, “intends to”, and similar expressions are intended to identify forward-looking statements. Such statements are subject to certain risks and uncertainties which could cause actual results to differ materially from those projected. These risks and uncertainties, many of which are not within the Company’s control, include, but are not limited to, the uncertainty and timing of the successful development of the Company’s new products, particularly in the optical thin films area, the risks associated with reliance on a few key customers; the Company’s ability to maintain compliance with requirements for continued listing on the Nasdaq SmallCap Market; the Company’s ability to attract and retain personnel with the necessary scientific and technical skills, the timing and completion of significant orders; the timing and amount of the Company 46;s research and development expenditures; the timing and level of market acceptance of customers’ products for which the Company supplies components; performance of the Company’s vendors; the ability of the Company to control costs associated with performance under fixed price contracts; and the continued availability to the Company of essential supplies, materials and services; which are described further in Exhibit 99.1 hereto. Readers are cautioned not to place undue reliance on these forward looking statements, which speak only as of the date hereof. The Company undertakes no obligation to publicly release the result of any revision to these forward-looking statements 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. 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 is currently developing specialty instruments incorporating its patent-pending LENSLOCK™ technology which ensures lower cost, easier repairability and enhanced durability as well as 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 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 and services, which have been principally sold to original equipment manufacturer (OEM) customers, is based on performance and other technical features, as well as other factors, such as scheduling and reliability, in addition to competitive price.

The Company 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

The Company recognizes revenue in accordance with U.S. GAAP and SEC Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition in Financial Statements.* 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 or determinable; and (4) collectibility is reasonably assured. Determination of criteria (3) and (4) are based on managements judgments regarding the fixed nature of the price to the buyer charged for products delivered or services rendered and collectibility of the sales price. The Company assesses credit worthiness of customers based upon prior history with the customer and assessment of financial condition. The Companys shipping terms are customarily FOB shipping point.

Bad Debt

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

Inventories

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

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

The Company accounts for impairment of long-lived assets in accordance with SFAS No. 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.

Fiscal Year 2004 Results of Operations

Total revenues for fiscal year 2004 of approximately $1,465,000 decreased by $934,000, or 38.9%, from fiscal year 2003 revenues of approximately $2,399,000.

The revenue decrease from the prior year was due principally to lower unit volume sales of medical products (down 44%), partially offset by higher unit volume sales of non-medical products (up 50%). Medical sales were lower due primarily to lower sales of stereo endoscope products because of the loss of business from a major stereo endoscope customer, as previously reported. Non-medical sales were higher due primarily to higher sales of couplers for industrial use.

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

	2004	2003	2002
Customer A	24%	17%	18%
Customer B	22	2	—
Customer C	—	44	—
Customer D	4	5	23
All Others	50	32	59
	100%	100%	100%

No other customer accounted for more than 10% of the Company’s revenues in fiscal years 2004, 2003, and 2002.

Gross profit (loss) for fiscal year 2004 reflected an unfavorable change of approximately $925,000 compared to fiscal year 2003. Gross profit as a percentage of revenues decreased from 13.6% in fiscal year 2003 to a negative 40.8% in fiscal year 2004. The unfavorable change in gross profit (loss) was due primarily to lower sales volume and provisions for slow moving and obsolete inventories, partially offset by a lower manufacturing cost structure resulting from restructuring measures implemented in fiscal year 2003.

Research and development expenses increased by approximately $84,000, or 6.8%, during fiscal year 2004 compared to the previous year. The increase was due to a higher level of resources being devoted to product development activities.

Selling, general and administrative expenses decreased by approximately $149,600, or 8.0%, during fiscal year 2004 compared to the previous year. The decrease was due primarily to lower outside consulting and legal expenses and the effects of the workforce reduction in January 2004.

The provision for asset impairment and restructuring in fiscal year 2004 of $52,208 consists of a provision for severance benefits paid in the quarter ended March 31, 2004 related to the January 2004 workforce reduction of 15%, or five employees. The provision for asset impairment and restructuring of $176,642 in fiscal year 2003, consists of a provision for severance benefits of $53,131 paid in the quarter ended December 31, 2002 related to the October 2002 workforce reduction of 16%, or six employees, and a provision for asset impairment of $123,511 recorded in the quarter ended June 30, 2003, representing a further writedown of assets held for sale which reflected the continuing deterioration in the market for used telecommunications equipment.

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

	Provision For —				
	Property & Equipment Writedown	**Patent Writedown**	**Employee Severance**	**Idle Lease Space**	**Total**
Provision Balance, June 30, 2002	$ —	$ —	$ —	$ 167,971	$ 167,971
Quarter Ended —					
December 31, 2002		—	53,131	—	53,131
June 30, 2003	123,511	—	—	—	123,511
Total Provision	123,511	—	53,131	—	176,642
Non-cash Charges	(123,511)	—	—	—	(123,511)
Cash Payments	—	—	(53,131)	(167,971)	(221,102)
Provision Balance, June 30, 2003	$ —	$ —	$ —	$ —	$ —
Quarter Ended —					
March 31, 2004	—	—	52,208	—	52,208
Total Provision	—	—	52,208	—	52,208
Cash Payments	—	—	(52,208)	—	(52,208)
Provision Balance, June 30, 2004	$ —	$ —	$ —	$ —	$ —

Interest income decreased by approximately $47,400 or 72.4% during fiscal year 2004 compared to the previous year. The decrease was due to the lower base of cash and cash equivalents.

Interest expense consists of interest on capital lease obligations and decreased due to the liquidation of capital lease obligations during fiscal year 2004.

The income tax provisions in fiscal years 2004 and 2003 represent the minimum statutory state income tax liability.

<u>Fiscal Year 2003 Results of Operations</u>

Total revenues for fiscal year 2003 of approximately $2,399,000 increased by $625,000, or 35.2%, from fiscal year 2002 revenues of $1,774,000.

The revenue increase from the prior year was due principally to higher unit volume sales of medical products (up 57%), partially offset by lower unit volume sales of non-medical products (down 60%). Medical sales were higher due primarily to higher sales of stereo endoscopes and cameras. Non-medical sales were lower due primarily to the discontinuation during the last fiscal year of sales of telecommunication products.

Gross profit for fiscal year 2003 reflected a favorable change of approximately $1,676,000, compared to fiscal year 2002. Gross profit as a percentage of revenues increased from a negative 76.0% in fiscal year 2002 to 13.6 % in fiscal year 2003. The favorable change in gross profit was due primarily to (1) a provision for excess and obsolete inventories of DWDM filters and DWDM filter test instrumentation of approximately $540,000 recorded in the quarter ended September 30, 2001; (2) lower fixed manufacturing costs resulting from the cessation of operations in the Company's optical thin film technology facility and reductions in staff; and (3) the higher overall sales volume.

Research and development expenses decreased by approximately $1,036,000, or 45.6%, during fiscal year 2003 compared to the previous year. During the fiscal year 2002, research and development expenses consisted primarily of development efforts related to DWDM filters used in telecommunications systems. The decrease in the fiscal year 2003 was due to discontinuation of the development of DWDM filters, as reflected in reductions in staff, and the remaining R&D resources being redeployed toward development of new medical products.

Selling, general and administrative expenses decreased by approximately $199,000, or 9.6%, during fiscal year 2003 compared to the previous year. The decrease was due primarily to lower sales and marketing expenses, partially offset by approximately $40,000 in expenses related to effecting a 1-for-6 reverse stock split in the quarter ended March 31, 2003.

The provision for asset impairment and restructuring of $176,642 in fiscal year 2003 consists of a provision for severance benefits of $53,131 paid in the quarter ended December 31, 2002 related to the October 2002 workforce reduction of 16%, or six employees, and a provision for asset impairment of $123,511 recorded in the quarter ended June 30, 2003, representing a further writedown of assets held for sale which reflects the continuing deterioration in the market for used telecommunications equipment. The provision for asset impairment and restructuring of $4,445,021 in fiscal year 2002 consists of (1) a provision for restructuring costs of $402,065, representing the then - present value of future lease payments related to idle space in the Company's Optical Thin Films Technology Center, and employee severance costs; and (2) a provision for asset impairment of $4,042,956, representing a writedown to the lower of carrying value or fair market va lue less estimated selling costs of certain of the Company's property and equipment invested in its optical thin films coating product line, and the writeoff of certain patent costs.

The loss on sale of assets held for sale of $19,171 in fiscal year 2003 represents the loss on sales of a portion of the property and equipment held for sale, which formerly was invested in the Company's telecommunications product line. The Company received net proceeds from these sales of approximately $553,000 in the year ended June 30, 2003.

Interest income decreased by approximately $127,000, or 66.0%, during fiscal year 2003 compared to the previous year. The decrease was due to the lower base of cash and cash equivalents and lower interest rates.

Interest expense consists of interest on capital lease obligations and, for fiscal year 2002, imputed interest on accrued restructuring costs related to the present value of future lease payments on idle space. Interest expense decreased by $13,069, or 65.5%, from fiscal year 2002 due primarily to the elimination of imputed interest on restructuring costs which were paid in early fiscal year 2003.

The income tax provisions in fiscal years 2003 and 2002 represent the minimum statutory state income tax liability.

Liquidity and Capital Resources

The Company has incurred significant operating losses during the last eight fiscal years. This trend was primarily the result of the loss of several significant customers, completion of several large nonrecurring government contracts, and operating losses and provision for asset impairment, restructuring, and inventory write-downs associated with the downturn in demand for optical filters used in telecommunications systems. In fiscal 1998, the Company began making significant investments in research and development and capital purchases for new products. In August 1999 and March 2000, the Company raised gross proceeds of approximately $16 million of additional cash through the issuance of common stock.

In the past three 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. Full-time employee headcount has been reduced from 78 at June 30, 2001 to 30 at June 30, 2004. The Company has discontinued the development and manufacturing of telecommunications products, canceled the lease on its Optical Thin Films Technology Center, and written down and/or sold certain of the property, equipment and inventories invested in its telecommunications business, and has implemented other cost reduction measures. As a result of these actions, the Company has incurred asset impairment, restructuring and inventory write-down provisions of approximately $4,985,000, $177,000 and $52,000 for the years ended June 30, 2002, 2003, and 2004 respectively, and has received net proceeds from the sale of assets held for sale of approximately $553,000 during the yea r ended June 30, 2003. In addition, the Company will continue its review of other expense areas to determine where additional reductions in discretionary spending can be achieved.

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 expenses of $177,176) were $5,078,983.

For the year ended June 30, 2004, the Company's cash and cash equivalents decreased by approximately $3,161,000 to $343,000. The decrease in cash and cash equivalents was due to cash used by operating activities of approximately $3,074,000, capital expenditures of approximately $34,000, repayment of capital lease obligation and other of approximately $4,000, expenditures for other assets (primarily patents) of $31,000 and payment of deferred financing costs of $18,000. The Company believes, based on its operating and strategic plans and the net proceeds received in July 2004 from its rights offering to stockholders, that it will have sufficient funds to conduct operations through at least the next fiscal year.

Contractual cash commitments for the fiscal years subsequent to June 30, 2004 are summarized as follows:

	2005	Thereafter	Total
Operating leases	$ 27,454	$ 2,183	$ 29,637

Trends and Uncertainties That May Affect Future Results

For the quarter ended June 30, 2004, cash and cash equivalents decreased by approximately $602,000 compared to a decrease of approximately $781,000 for the previous quarter ended March 31, 2004. Cash disbursements during the quarter ended March 31, 2004 included approximately $52,000 paid for employee severance costs.

Capital equipment expenditures during the year ended June 30, 2004 were approximately $33,600, up 21% from the $28,000 for fiscal year 2003. Future capital equipment expenditures will be dependent upon future sales and success of on-going research and development efforts.

For the quarter ended June 30, 2004, research and development expenses were approximately $339,000, up 1.8% from the $333,000 for the quarter ended June 30, 2003. It is anticipated that the quarterly level of R&D expenses for the foreseeable future will remain at this lower level, but is ultimately dependent upon the Company's assessment of new product opportunities.

The Company expects its recent pattern of quarter-to-quarter revenue fluctuations to continue, due to the uncertain timing of 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 development of a new prototype 2.7 mm endoscope, and new instruments utilizing the Company's new micro-precision™ 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 7. CONSOLIDATED FINANCIAL STATEMENTS: The Consolidated Financial Statements are filed on pages 17 through 36 of this Form 10-KSB.

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

Consolidated Financial Statements
as of June 30, 2004 and 2003
Together with Independent Registered Public Accounting Firm□s Report

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Report of Independent Registered Public Accounting Firm

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

We have audited the accompanying consolidated balance sheets of Precision Optics Corporation, Inc. and subsidiaries as of June 30, 2004 and 2003 and the related consolidated statements of operations, stockholders’ equity and cash flows for each of the years in the three-year period ended June 30, 2004. These consolidated financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Precision Optics Corporation, Inc. and subsidiaries as of June 30, 2004 and 2003 and the results of their operations and their cash flows for each of the years in the three-year period ended June 30, 2004 in conformity with accounting principles generally accepted in the United States of America.

/s/ KPMG LLP

Boston, Massachusetts
August 31, 2004

PRECISION OPTICS CORPORATION, INC. AND SUBSIDIARIES

Consolidated Balance Sheets
June 30, 2004 and 2003

ASSETS	2004	2003	LIABILITIES AND STOCKHOLDERS' EQUITY	2004	2003
Current Assets:			Current Liabilities:		
Cash and cash equivalents	$ 343,260	$ 3,504,414	Current portion of capital lease obligation	$	$ 3,826
			Accounts payable	235,050	141,398
Accounts receivable (net of allowance for doubtful accounts of approximately $155,000 in 2004 and 2003).	80,195	191,669	Accrued employee compensation	230,110	213,543
Inventories	917,998	1,257,288	Accrued professional services	75,439	118,284
Prepaid expenses	80,646	91,213	Accrued warranty expense	50,000	