

PRECISION OPTICS CORPORATION INC
Form 10KSB
September 28, 2007

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

FORM 10-KSB

(Mark One)

ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Fiscal Year Ended June 30, 2007

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For transition period from ____ to ____

Commission File Number **001-10647**

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

MASSACHUSETTS
(State or other jurisdiction
of incorporation or organization)

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

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

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

Securities registered under Section 12(b) of the Act: **None**

Securities registered under Section 12(g) of the Act: **Common Stock, \$.01 par value**

Check whether the issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act.

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 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.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

The issuer's revenues for its most recent fiscal year were \$2,477,469.

The aggregate market value of the voting stock, consisting solely of common stock, held by non-affiliates of the issuer computed by reference to the closing price of such stock was \$2,278,356 as of August 31, 2007.

The number of shares of outstanding common stock of the issuer as of August 31, 2007 was 25,458,212.

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

DOCUMENTS INCORPORATED BY REFERENCE

The issuer's Proxy Statement for the 2007 Annual Meeting of Shareholders to be held on November 27, 2007 is incorporated by reference into Part III of this Form 10-KSB.

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PART I

ITEM 1. DESCRIPTION OF BUSINESS

*This Annual Report contains forward-looking statements as defined under the federal securities laws. Actual results could vary materially. Factors that could cause actual results to vary materially are described herein and in other documents. Readers should pay particular attention to the considerations described in the section of this report entitled “**Managements Discussion and Analysis of Financial Condition and Results of Operations - Factors That May Affect Future Results and Market Price of Stock.**” Readers should also carefully review any risk factors described in other documents the Company files from time to time with the Securities and Exchange Commission.*

Where we say “we”, “us”, “our”, or the “Company”, we mean Precision Optics Corporation or Precision Optics Corporation and its subsidiaries, as applicable. Where we refer to the “industry”, we mean the optical instruments manufacturing industry. Certain statements in this Annual Report contain words such as “could”, “expects”, “may”, “anticipates”, “believes”, “intends”, “estimates”, “plans”, “envisions”, “seeks” and other similar language and are considered forward looking statements or information under applicable securities laws. These statements are based on our current expectations, estimates, forecasts and projections about the operating environment, economies and markets in which we operate. These statements are subject to important assumptions, risks and uncertainties, which are difficult to predict and the actual outcome may be materially different. Although we believe expectations reflected in such forward-looking statements are reasonable based upon the assumptions in this Annual Report, they may prove to be inaccurate and consequently our actual results could differ materially from our expectations set out in this Annual Report.

HISTORY

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, Inc., a developer and manufacturer of advanced optical instruments since 1982, designs and produces high-quality medical instruments, optical thin film coatings, micro-optics with characteristic dimensions less than 1 mm, and other advanced optical systems. The Company’s 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 registered to the ISO 9001:2000, ISO 13485:2003, and CMDCAS Quality Standards, and comply with the FDA Good Manufacturing Practices and the European Union Medical Device Directive for CE Marking of our medical products. The Company’s internet website is www.poci.com.

Principal Products and Services and Methods of Distribution.

Medical Products: Endoscopes and Image Couplers. The Company’s medical products include endoscopes, as well as image couplers, beamsplitters and adapters, all of which are used as accessories to endoscopes. Since January 1991, the Company has developed and sold endoscopes incorporating various optical technologies for use in a variety of minimally invasive surgical and diagnostic procedures. The Company’s current line of specialized endoscopes include arthroscopes (which are used in joint surgery), laryngoscopes (which are used in the diagnosis of diseases of the larynx), laparoscopes (which are used in abdominal surgery), ENT scopes (which are used for ear, nose and throat procedures) 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).

The Company produces autoclavable endoscopes for various applications, which are CE mark certified for European use, and have been designed and tested to withstand sterilization by autoclave (sterilization in superheated steam under pressure), as well as all other commonly used medical sterilization means. The major benefits of instruments that can be autoclaved include increased patient safety, quick turnaround, and elimination of hazardous sterilant and by-product materials, all of which provide increased value to the user compared to alternative sterilization methods.

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 (for example, the Series 200 Parfocal Zoom Couplers and the Series 950 Universal Couplers), which physically connect the endoscope to a video camera system and transmit the image viewed through the scope to the video camera. The Company's Series 800 Beamsplitters perform the same function while preserving for the viewer an eye port for direct, simultaneous viewing through the endoscope. These devices are sold primarily to endoscope and video camera manufacturers and suppliers for resale under the Company's customers' names. All of the image couplers and beamsplitters manufactured by the Company are approved for surgery-approved sterilization. Further, the Company believes it is one of only a few manufacturers of autoclavable image couplers worldwide.

Medical Products: Next Generation Lenslock™ Endoscopes. The Company continues to develop and ship its next generation endoscopes that incorporate its leading proprietary Lenslock™ technology (patent pending). Since December 2005, over 250 ENT endoscopes with diameter of 2.7 mm that incorporate Lenslock™ technology have been shipped. The Company is currently launching its 4 mm Lenslock™ sinuscope, finalizing development of its 5 mm Lenslock™ laproscope, and is actively pursuing development of its new 4 mm Lenslock™ wide field arthroscope. All of these Lenslock™ endoscopes are expected to be in production in the near future. The Company believes that Lenslock™ technology has advantages over competitive products due to ease of manufacture and repair, superior image quality, significant cost effectiveness and quality of repair and that further incorporating this into its endoscope product line will lead to increased sales.

Medical Products: Sub-millimeter optics & endoscopes: Utilizing recently developed proprietary techniques, including patent pending micro-precision™ lens fabrication technology, the Company designs and manufactures ultra-small lenses, prisms, and assemblies with sizes as small as 0.2 mm. Assemblies range in complexity from the combination of two lens elements to entire imaging systems utilizing multiple micro-optical elements in combination with larger, conventional optics. Developments in medical procedures requiring minimally invasive visualization in very small spaces, in such specialties as spinal surgery, neurosurgery, cardiothoracic surgery, cardiology and pulmonology, have led to products requiring lenses and endoscopes as small as 0.2 millimeters in diameter. Utilizing its proprietary technology, the Company currently manufactures a number of products with length and / or diameter less than 1 mm and is actively expanding its product line in this area.

Medical Products: Custom design & device production. The Company designs, prototypes and manufactures custom optical medical products to satisfy customers' specific requirements. During fiscal year 2007, the Company completed development and began shipments of an advanced surgical visualization system to a significant new customer. Possible follow-on orders will be dependent on market acceptance and other considerations and no assurances regarding any such order can be made.

Industrial Products. In addition to its medical products, the Company also sells components, and assemblies such as image couplers and beamsplitters specially designed for industrial use, including the video-monitored examination of a variety of industrial cavities and interiors, as well as specialized borescopes for industrial applications. Utilizing micro-precision™ technology, the Company also designs and manufactures sub-millimeter optical components and assemblies for industrial use.

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 use in the Company's medical

instrumentation and other products. In addition, the company designs and manufactures custom thin film products. The Company recently began shipping a new, proprietary industrial filter which was developed over the past eighteen months for a specific customer.

Night Vision Optics. The Company has 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 Company is beginning to manufacture lenses in pre-production quantities. The product incorporating the Company's new night vision lenses is currently being evaluated for need and use, including field testing. The Company cannot control the timing of current evaluations and cannot therefore predict when, if ever, these night vision lenses might begin to generate revenue. Should the Company's customer secure orders for its night vision system, the partnership agreement ensures we will either be contracted to manufacture the new lenses, or will receive royalties on lenses manufactured elsewhere.

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Optical System Design and Development Services. The Company is able to provide customers with 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 efforts 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 Company sells its products in a highly competitive market and it competes for business with both foreign and domestic manufacturers. Many of the Company's current competitors are larger and have substantially greater resources than the Company. In addition, there is an ongoing risk for the Company that other domestic or foreign companies who do not currently service or manufacture products for the Company's target markets, some with greater experience in the optics industry and greater financial resources than the company, may seek to produce products or services that compete directly with those of the Company.

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 pricing. The Company markets and sells its endoscopes to suppliers of original equipment manufacturer (OEM) video cameras and video endoscopes for incorporation into their own product lines and for resale under their own 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 product quality, 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 who manufacture and sell video cameras, endoscopes, and video-endoscopy systems. In the past, the Company has been successful in marketing and selling its products to approximately two-thirds of these customers, and currently estimate that it maintains approximately 20% to 30% of the market share in these products. The Company plans to continue to focus its sales and marketing efforts in this area, and to work to increase its market share. However, a challenge the Company faces is customers' own in-house capabilities to manufacture such products, for which it estimates that approximately 50% of the market demand for image couplers, beamsplitters, and adapters is met by these "captive" facilities. In general, and despite in-house capacity, the Company believes that many customers continue to purchase products from the Company in order to devote their own technical resources to their primary products, such as cameras or endoscopes.

During the past year and one-half, the Company has added significant new resources with the addition of a director of marketing with special experience in broad market initiatives, especially in the medical field. Together with the Company's existing sales and marketing staff, this team has already begun a number of efforts to strengthen the Company's market presence. This has included a newly designed website (www.poci.com), and a much more comprehensive view of trade show opportunities. Coupled with the recently renewed efforts for select key trade show attendance by the Company's Chief Scientific Officer and its Chief Executive Officer, as well as its overall sales and marketing staff, the Company believes it has a greater opportunity to reach and follow up a broader customer base than the Company has heretofore been able to achieve. A number of new opportunities are already leading to customer discussions for prospects for the Company's leading technologies including, Lenslock™, micro-precision™, and custom applications of the Company's core optical capabilities. This includes renewed interest in some of the Company's well-developed products such as its "classic" autoclavable endoscopes, and endocouplers, as well as new applications with the Company's micro (fiberoptic) endoscopes.

As an additional service component, 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 reputation and prior experience, which the Company believes it can provide to its customers on a cost efficient basis.

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

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 \$1,312,000 and \$1,106,000 of its own funds (net of reimbursements) during fiscal years 2007 and 2006, respectively, on research and development.

The Company is currently incorporating its Lenslock™ technology (patent pending) into its line of endoscopes. This proprietary technology ensures lower cost, easier reparability and enhanced durability. The Company is also aggressively pursuing the design, development and manufacture of ultra-small instruments (some with lenses less than one millimeter in diameter) utilizing its micro-precision™ lens technology (patent pending). The Company is also exploring new initiatives in single-molecule technology and nanotechnology for biomedical and other applications.

Raw Materials and Principal Suppliers.

The basic raw material of the majority of the Company's product line is precision grade optical glass, which the Company obtains from several major suppliers. 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 2008. The Company believes, however, that there are relatively few suppliers of the high quality lenses and prisms which its endoscopes require. In response, the Company has established its own 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.

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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, including those for its new generation of 3-D endoscopes, its leading Lenslock™ endoscope technology, and its innovative micro-precision™ lens technology. The Company knows of no infringements of its patents. The Company plans to protect its patents from infringement in each instance where it determines that doing so would be economical in light of the expense involved and the level and availability of the Company's financial resources. While the Company believes that its pending applications relate to patentable devices or concepts, there can be no assurance that patents will be issued or that any patents issued can be successfully defended or will effectively limit the development of competitive products and services.

Employees.

As of June 30, 2007, the Company had 35 full time employees and 7 part time employees. There were 21 employees in manufacturing, 12 in engineering/research and development, 3 in sales and marketing, and 6 in finance and administration.

Customers.

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

	2007	2006
Customer A	27%	18%
Customer B	22	15
Customer C	10	15
All Others	41	52
	100%	100%

No other customer accounted for more than 10% of the Company's revenues in fiscal years 2007 and 2006.

Environmental Matters.

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.

Government Regulations on the Business.

Domestic Regulation. The Company currently develops, manufactures and sells several medical products, the marketing of which is subject to governmental regulation in the United States. Medical devices are regulated in the United States by the Food and Drug Administration ("FDA") and, in some cases, by certain state agencies. The FDA regulates the research, testing, manufacture, safety, effectiveness, labeling, promotion and distribution of medical devices in the United States. Generally, medical devices require clearance or approval prior to commercial distribution. Additionally, certain material changes to, and changes in intended use of, medical devices also are

subject to FDA review and clearance or approval. Non-compliance with applicable requirements can result in failure of the FDA to grant pre-market clearance or approval, withdrawal or suspension of approval, suspension of production, or the imposition of various other penalties.

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The Company provided notification to the FDA of its intent to market its endoscopes, image couplers, beamsplitters, adapters and video ophthalmoscopes, and 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 due to the FDA's determination that such devices meet the regulatory standard of being substantially equivalent to an existing approved device.

In the future, the Company plans to market additional endoscopes and related medical products that may require the FDA's permission to market such products. The Company may also develop additional products or seek to sell some of its current or future medical products in a manner that requires the Company to obtain the permission of the FDA to market such products, as well as the regulatory approval or license of other federal, state, and local agencies or similar agencies in other countries. The FDA has authority to conduct detailed inspections of manufacturing plants in order to assure that "good manufacturing practices" are being followed in the manufacture of medical devices, to require periodic reporting of product defects to the FDA, and to prohibit the sale of devices which do not comply with law.

Foreign Requirements. Sales of medical device products outside the United States are subject to foreign regulatory requirements that may vary from country to country. Our failure to comply with foreign regulatory requirements would jeopardize our ability to market our products in foreign jurisdictions. The regulatory environment in the European Union for medical device products differs from that in the United States. Medical devices sold in the European Economic Area must bear the CE mark. Devices are classified by manufacturers according to the risks they represent, with a classification of Class III representing the highest risk devices and Class I representing the lowest risk devices. Once a device has been classified, the manufacturer can follow one of a series of conformity assessment routes, typically through a registered quality system, and demonstrate compliance to a "European Notified Body." The CE mark may then be applied to the device. Maintenance of the system is ensured through annual on-site audits by the notified body and a post-market surveillance system requiring the manufacturer to submit serious complaints to the appropriate governmental authority. All of the Company's medical products are CE mark certified.

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 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 2007.

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PART II**ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS**

The Company's common stock is quoted on the OTCBB under the symbol "POCI.OB." Prior to December 27, 2005, the Company's common stock was listed on the NASDAQ Capital Market® under the symbol "POCI." Set forth below are the high and low sales prices or bid prices for the Company's common stock for each quarter during the last two fiscal years as quoted on the OTCBB or listed by NASDAQ, as applicable. The quotes from the OTCBB reflect inter-dealer prices, without retail markup, markdown or commissions and may not represent actual transactions. The information below was obtained from those organizations, for the respective periods.

Quarter	2007 High	Low	2006 High	Low
First	\$ 0.49	\$ 0.25	\$ 0.90	\$ 0.45
Second	\$ 0.49	\$ 0.25	\$ 0.80	\$ 0.20
Third	\$ 0.60	\$ 0.32	\$ 0.50	\$ 0.20
Fourth	\$ 0.50	\$ 0.32	\$ 0.71	\$ 0.32

On February 1, 2007, the Company sold an aggregate of 10,000,000 shares of common stock, par value \$0.01 per share, at a price of \$0.25 per share and warrants to purchase an aggregate of 10,000,000 shares of common stock at an exercise price of \$0.32 per share, which were immediately exercisable, raising gross proceeds of \$2,500,000. All of the following shares of common stock issued were issued in a non registered transaction in reliance on Section 4(2) of the Securities Act of 1933, as amended:

Purchaser	Common Stock Purchased*
Special Situations Fund III QP, L.P.	8,000,000
Special Situations Private Equity Fund, L.P.	8,000,000
Joel Pitlor (a)	2,000,000
Arnold Schumsky	1,200,000
LaPlace Group LLC	800,000

* Includes shares of common stock and shares underlying outstanding warrants

(a) Director of the Company

These shares and the shares of common stock issuable upon the exercise of the warrants were subsequently registered on a registration statement on a Form SB-2, which was declared effective by the Securities and Exchange Commission on March 23, 2007.

As of August 31, 2007, there were approximately 130 holders of record of the Company's common stock. Holders of record include nominees who may hold shares on behalf of multiple 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.

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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,” “could,” “expects,” “may,” “estimates,” “plans,” “envisions,” “seeks,” 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 our control, include, but are not limited to, the uncertainty and timing of the successful development of our new products; our ability to raise capital and to continue as a going concern; decisions by customers to place orders for our products; the risks associated with reliance on a few key customers; our 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 our research and development expenditures; the timing and level of market acceptance of customers’ products for which we supply components; performance of our vendors; our ability to control costs associated with performance under fixed price contracts; and the continued availability of essential supplies, materials and services. We caution investors not to place undue reliance on these forward looking statements, which speak only as of the date hereof. We undertake no obligation to revise or update these forward-looking statements to reflect events or circumstances that may occur after the date hereof or to reflect the occurrence of unanticipated events.

Overview

The Company, a developer and manufacturer of advanced optical instruments since 1982, designs and produces high-quality optical thin film