

PRO DEX INC  
Form 10-K  
September 17, 2009

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-K

**ANNUAL REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934.**

**For the fiscal year ended June 30, 2009**

**OR**

**TRANSITION REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934. FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_.**

**Commission File Number 0-14942**

UNITED STATES

**PRO-DEX, INC.**

(Name of small business issuer in its charter)

Colorado

(State or other jurisdiction of  
incorporation or organization)

84-1261240

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

2361 McGaw Avenue, Irvine, California

(Address of principal executive offices)

92614

(Zip Code)

Issuer's telephone number: (949) 769-3200

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

| <u>Title of each class</u> | <u>Name of each exchange<br/>on which registered</u> |
|----------------------------|--|
| Common Stock, no par Value | NASDAQ Capital<br>Market                             |

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

None

(Title of class)

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

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

Yes  No

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

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B 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-K or any amendment to this Form 10-K.

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company (as defined in Exchange Act Rule 12b-2).

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

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

Yes  No

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the average bid and asked price of such common equity as of December 31, 2008: \$2,856,336. For the purpose of this calculation, shares owned by officers, directors and 10% stockholders known to the registrant have been deemed to be owned by affiliates. This determination of affiliate status is not a determination for other purposes.

The number of shares outstanding of each of the issuer's classes of Common Stock outstanding as of the latest practicable date: 9,668,671 shares of Common Stock, no par value, as of September 11, 2009.

DOCUMENTS INCORPORATED BY REFERENCE: Part III incorporates by reference certain information from the registrant's definitive proxy statement (the "Proxy Statement") for the 2009 Annual Meeting of Shareholders.

**PRO-DEX, INC.**

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## **PART I**

### **Cautionary statement pursuant to safe harbor provisions of the Private Securities Litigation Reform Act of 1995.**

When used in this report on Form 10-K, the words "expects," "anticipates," "estimates," "believes," "hopes," "intends," "forecasts" and similar expressions are intended to identify "forward-looking statements." These statements which are not historical or current facts are made pursuant to the safe harbor provisions of Section 27a of the Securities Act of 1933, as amended and Section 21e of the Securities Exchange Act of 1934, as amended, and the Company intends that such forward-looking statements be subject to those safe harbor provisions for such statements. The Company wishes to caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date of this report. While forward-looking statements represent management's best judgment as to what may occur in the future, they are subject to risks, uncertainties and important factors beyond the control of the Company that could cause actual results and events to differ materially from historical results of operations and events as well as those presently anticipated or projected. These factors include adverse economic conditions, entry of new and stronger competitors, capital availability, unexpected costs, compliance with contractual obligations including, but not limited to covenants in lending agreements, failure to capitalize upon access to new customers, and marketplace delisting. Other risks and uncertainties which may affect forward-looking statements about the Company's business and prospects include, but are not limited to, the ramifications of the continued industry consolidation of dental and medical products manufacturers, dealers and distributors, managed health care, the Company's ability to effectively integrate operations of acquired companies, market acceptance and support of new products, maintaining favorable supplier relationships, the inability to engage qualified human resources as needed, regulatory compliance and general economic conditions. The Company disclaims any obligations subsequently to revise any forward-looking statements to reflect events or circumstances after the date of such statement or to reflect the occurrence of anticipated or unanticipated events.

#### **Item 1. Business**

##### **Company Overview**

Washington, D.C. 20549

Pro-Dex, Inc. ( Company, Pro-Dex , we, our, , us ), with operations in Irvine, California, Beaverton, Oregon and City, Nevada, provides a pathway to product solutions never envisioned by customers. A unique blend of creativity and systemic discipline enables us to develop and manufacture innovative designs that powerfully complete a customer s strategic product offering. Pro-Dex leverages extraordinary human collaboration and superior technical capability to power and control products used in medical, aerospace, military, research and industrial applications requiring high precision in harsh environments. With expertise in multi-axis motion control, fractional horsepower motors and rotary drive systems, we identify and create unexpected value for our customers.

Pro-Dex's products are found in hospitals, dental offices, medical engineering labs, commercial and military aircraft, scientific research facilities and high tech manufacturing operations around the world. The company names of Micro Motors, Oregon Micro Systems, and Astromec are used for marketing purposes as brand names.



Pro-Dex's principal headquarters are located at 2361 McGaw Avenue, Irvine, California 92614 and our phone number is 949-769-3200. Our Internet address is [www.pro-dex.com](http://www.pro-dex.com). Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, amendments to those reports and other SEC filings, are available free of charge through our website as soon as reasonably practicable after such reports are electronically filed with, or furnished to, the SEC. In addition, our Code of Ethics and other corporate governance documents may be found on our website at the Internet address set forth above. Our filings with the SEC may also be read and copied at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC at [www.sec.gov](http://www.sec.gov).

All years relating to financial data herein shall refer to fiscal years ending June 30, unless indicated otherwise.

## **Description of Business**

The majority of our revenue is derived from designing, developing and manufacturing rotary drive systems for the medical device and dental industries, motion control software and hardware for industrial and scientific applications, and fractional horsepower DC motors for aerospace, medical and military applications. A large part of the revenue of the Company has been driven by developing and selling numerous types of private label rotary drive systems for use in dental applications, and for cranial, spinal, arthroscopic and orthopedic surgery. Other revenue sources include designing and manufacturing miniature pneumatic motors, fractional horsepower DC motors and motion control systems for industrial applications in the semi-conductor, automotive, aerospace, and apparel industries.

Company-funded research and development supports the development of generic rotary drive, motion control, and electric motor technology platforms. Company-funded research and development projects are generally expected to convert to customer-funded projects within six to eighteen months. Company funded project costs not associated with signed contracts or purchase orders are expensed as incurred.

We seek customer-funded projects to customize generic rotary drive, motion control, and electric motor technology platforms to specific customer requirements. For customer-funded development projects, costs are capitalized and recognized as a cost of sales when specific deliverables within the development contracts are earned, matching the

costs to the revenue. Revenue related to these fees can vary greatly due to the timing of contract milestones that prompt the revenue recognition. The results of customer-funded development work are intended to provide long-term exclusive manufacturing agreements and generally provide the customer with the retention of part of the intellectual property developed. The identity of our customers is generally protected by a non-disclosure agreement.

The fees earned are classified as revenue as opposed to reimbursement against expense as part of the technology we are contracted to produce is not retained by us, but rather transferred to the funding company for future economic benefit.

Contract revenue for customer funded research and development is principally recognized based on the achievement of contractual milestones and the Cost of Sales (COS) is recognized as the ratio of total actual incurred costs to date to total estimated costs for each contract (cost-to-cost method) in accordance with Statement of Position No. 81-1,

Accounting for Performance of Construction-Type and Certain Production-Type Contracts. Generally, we review cost performance and estimates to complete on our ongoing contracts at least annually. The impact of revisions of profit estimates are recognized on a cumulative catch-up basis in the period in which the revisions are made.

Our estimates of contract costs are based on expectations of costs to deliver the milestone. These estimates can change based on unforeseen technology and integration issues, but known risk factors and contract challenges are generally allowed for in the initial scope and cost estimate of the program. Revisions in profit estimates are charged to income in the period in which the facts that give rise to the revision become known. In certain circumstances, specific contracts in which the Company cannot reliably make estimates of total revenues and expenses are accounted for under the completed contract method. Under the completed contract method, all revenue and expenses attributable to the specific contract are deferred until the end of the project.

| Customer-funded development (\$'000) | Year Ended June 30, |      |       |            |
|--------------------------------------|---------------------|------|-------|------------|
|                                      | 2009                |      | 2008  |            |
| Revenue                              | \$                  | 390  | \$    | 470        |
| Cost of Sales                        |                     | 476  |       | 119        |
| Gross Profit and Margin              | \$                  | (86) | (22%) | \$ 351 75% |

In fiscal year 2009, there was an \$80,000 decrease in revenue from customer-funded research and development compared to fiscal year 2008 as engineering fee billings associated with customer projects have been completed and the capitalized expenses related to the projects were expensed. We recognized an \$86,000 loss on our customer-funded research and development compared to last year's \$351,000 gain due to end-of project cost overruns.

Our revenue is derived from five main customer types. The proportion of total sales to each customer type and sales by location are noted in the tables below:

| Sales by customer type (\$'000) | 2009 |        | 2008 |    | 2007   |      | 2006 |        |      |    |        |      |
|---------------------------------|------|--------|------|----|--------|------|------|--------|------|----|--------|------|
| Dental                          | \$   | 2,620  | 12%  | \$ | 3,290  | 13%  | \$   | 3,476  | 16%  | \$ | 3,789  | 22%  |
| Medical                         |      | 11,107 | 53%  |    | 14,121 | 56%  |      | 10,275 | 48%  |    | 6,447  | 38%  |
| Industrial                      |      | 2,448  | 12%  |    | 3,279  | 13%  |      | 3,317  | 15%  |    | 3,753  | 22%  |
| Aerospace                       |      | 2,624  | 12%  |    | 2,382  | 9%   |      | 2,445  | 11%  |    | 1,194  | 7%   |
| Repairs, Government and other   |      | 2,324  | 11%  |    | 2,054  | 8%   |      | 2,050  | 10%  |    | 1,878  | 11%  |
| Total Sales                     | \$   | 21,122 | 100% | \$ | 25,126 | 100% | \$   | 21,563 | 100% | \$ | 17,061 | 100% |

| Sales by location (\$'000) | 2009 | 2008 | 2007 | 2006 |
|----------------------------|------|------|------|------|
|----------------------------|------|------|------|------|

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|                     |           |      |           |      |           |      |           |      |
|---------------------|-----------|------|-----------|------|-----------|------|-----------|------|
| Irvine              | \$ 15,637 | 74%  | \$ 18,268 | 73%  | \$ 13,852 | 64%  | \$ 10,823 | 63%  |
| Beaverton           | 2,241     | 11%  | 3,443     | 14%  | 4,121     | 19%  | 4,585     | 27%  |
| Carson City*        | 3,429     | 16%  | 3,453     | 14%  | 3,590     | 17%  | 1,653     | 10%  |
| Interlocation sales | (185)     | (1%) | (38)      | -    | -         | -    | -         | -    |
| Total Sales         | \$ 21,122 | 100% | \$ 25,126 | 100% | \$ 21,563 | 100% | \$ 17,061 | 100% |

\*2006 for Carson City represents 6 months of sales from time of asset acquisition completion

The majority of the Irvine based sales include medical products that utilize proprietary designs developed by us under exclusive design and supply agreements. Our dental products are primarily sold to original equipment manufacturers and dental product distributors. In Beaverton, we design and manufacture embedded multi-axis motion controllers used to regulate the motion of servo and stepper motors, predominantly for the factory automation, scientific research, and medical analysis equipment industries. Our Carson City products include high reliability fractional horsepower DC motors designed for harsh environments, primarily for the aerospace and medical markets.

In 2009, the top 20 customers accounted for 86% of our sales, compared to 81% in 2008. In 2009, our two largest customers accounted for 60% of such sales with the largest customer accounting for over 31% of our sales. This compares to 2008 when our two largest customers accounted for 50% of our sales with the largest customer accounting for 32% of such sales. Some of our larger customers include Smith and Nephew, Medtronic, Sullivan Schein, Thermo Fisher Scientific and Monogram. In many cases, including our two largest customers, disclosure of customer names is prohibited by confidentiality agreements with such entities. We have no plans to discontinue the sales relationships with our existing significant customers nor do we have knowledge of any plans by such customers to discontinue their relationships with us.

The majority of the raw materials used to manufacture our products is purchased from various suppliers and are available from several sources. Precipart Corporation, Tyco Precision Interconnect and Transicoil are some examples of our key suppliers. We have no exclusive arrangements with any of our suppliers, but in several instances only one supplier is used for certain high-value purchased components. We consider our relationships with our suppliers and manufacturers to be good. We do not intend to terminate any such relationship at this time, nor does management have knowledge that any supplier or manufacturer intends to terminate its relationship with us.

Our commitment to quality design and manufacturing are demonstrated by our three independently verified certifications for maintaining quality processes and products. We hold the following certifications: ISO 13485:2003, the Medical Device Directive 93\42\EEC Annex II, and CMDCAS (Canadian Medical Device Regulation).

At the present time, we are generally able to fill orders for recurring product within sixty (60) days from initial order receipt. At June 30, 2009, we had a backlog, including orders for delivery beyond 60 days, of \$9.8 million compared with a backlog of \$10.4 million at June 30, 2008. We expect to ship most of our backlog in fiscal year 2010 and the remainder in fiscal year 2011. The decrease from June 2008 is due to normal fluctuations in the timing of receipt and shipment of orders. We do not typically experience seasonal fluctuations in our new order bookings, but may experience variability in our new order bookings due to the timing of major new product launches. Similarly, we do not typically experience seasonal fluctuations in our shipments and revenues.

## **Competition**

The markets for products in the healthcare, fractional motors, motion control and factory automation industries are intensely competitive, and we face significant competition from a number of different sources. Several of our competitors have significantly greater name recognition as well as substantially greater financial, technical, product development and marketing resources than us.

We compete in all of our markets with other major healthcare, fractional motors, motion control and factory automation related companies. Competitive pressures and other factors, such as new product or new technology introductions by us or our competitors, may result in price or market share erosion that could have a material adverse effect on our business, results of operations and financial condition. Also, there can be no assurance that our products and services will achieve broad market acceptance or will successfully compete with other products targeting the same customers.

## **Research and Development**

We conduct company-funded and customer-funded research and development programs. These product development programs are important to both maintain and improve our market position. Our research and development effort involves the design and manufacture of products that perform specific applications for our customers. We continue to target our research and development expenses toward three goals:

- expanding our knowledge base in the medical device, fractional motor and motion control industry to solidify our products with current customers and expand our customer base;
- general technical advances; and
- enhancements of current product lines.

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We may share research and development costs with our customers by billing for non-recurring engineering expenses. The fees received for non-recurring engineering expenses do not, however, represent a significant portion of our revenue.

In the year ended June 30, 2009, \$2,790,000 was expensed for company-funded research and development; an increase of \$58,000 from the \$2,732,000 expensed in the year ended June 30, 2008. The increase was attributable to small motor product development, improvement and validation.

## **Employees**

At June 30, 2009, we had 127 full-time employees compared to 145 full-time employees at June 30, 2008. At June 30, 2009, there were 89 persons employed at the Irvine location, 29 persons employed at the Carson City location and 9 persons employed at the Beaverton location. At June 30, 2008, there were 104 persons employed at the Irvine location, 30 persons employed at the Carson City location and 11 persons employed at the Beaverton location.

None of our employees are a party to any collective bargaining agreements with us. We consider our relationships with our employees to be good.

## **Government Regulations**

Our manufacture and distribution of dental and medical devices are subject to a number of state and federal regulatory bodies, including state dental boards and the Food and Drug Administration ("FDA"). The statutes, regulations, administrative orders, and advisories that affect our businesses are complex and subject to diverse, often conflicting, interpretations. While we make every effort to maintain full compliance with all applicable laws and regulations, we are unable to eliminate an ongoing risk that one or more of our activities may at some point be determined to have been non-compliant. The penalties for non-compliance could range from an administrative warning to termination of a portion of our business. Furthermore, even if we are subsequently determined to have fully complied with applicable laws or regulations, our costs to achieve such a determination and the intervening loss of business could adversely affect or even terminate a portion of our business. A change in such laws or regulations at any time may have an

adverse effect on our operations. Notwithstanding the risks inherent in our business, management believes that our operations are in compliance with applicable laws and regulations.

The FDA regulates our dental and medical products as Class 1, Class 2 and Class 3 medical devices. The FDA has broad enforcement powers to recall and prohibit the sale of products that do not comply with federal regulations, and to order the cessation of non-compliant processes. No claim has been made to date by the FDA regarding any of our products or processes. Nevertheless, as is common in the industry, certain of our products and processes have been the subject of routine governmental reviews and investigations. While our management is confident that our products and processes fully comply with applicable laws and regulations, we are unable to predict the outcome of any such investigation or review, pending its completion.

We believe that our business is conducted in a manner consistent with Environmental Protection Agency ( EPA ) and other agency regulations governing disposition of industrial waste materials. While we are confident that our products and processes fully comply with applicable laws and regulations, we are unable to predict the outcome of any investigation or review which may in the future be undertaken with respect to our products or processes.

Our management believes that we follow Good Manufacturing Practices for all of our products at each of our locations.



## **Patents, Trademarks, and Licensing Agreements**

We hold patents relating to intraosseous dental anesthesia delivery, multi-axis motion controllers and miniature rotary drive products. Our patents have varying expiration dates. The near term expiration of the patents, if any, is not expected to cause any change in the Company's revenue generating operations as the revenue from the products associated with those patents would not be material.

We believe that the use of the patents acquired in connection with the 1995 OMS and Micro Motors acquisitions as well as the patents acquired with the intraosseous dental anesthesia delivery ( Intraflow ) acquisition do not infringe upon the intellectual property of any third party. nor are we aware of any infringement of such rights by any third party, except for one instance in which the Intraflow patents owned by us may have been infringed by a third party.

We are taking actions to protect our rights under those patents. We are unable to assess the validity, scope, or defensibility of our patents with any degree of certainty, and any challenge to or claim of infringement relating to our patents could materially and adversely affect our business and results of operations.

We have certain trademarks relating to our products, including OMS-EZ™, and The Company in Motion™. We have filed for federal trademark protection for Pro-Dex, OMS, and Intraflow.

We have not entered into any licensing or franchising agreements for revenue generating purposes; however we do have a royalty agreement in place for a previously designed product. This income is reflected as other income and not revenue.

## **Item 1A. RISK FACTORS**

**We face significant competition from a number of different sources which could negatively impact our results of operations and business conditions.**

The markets for healthcare, factory automation and small motor manufacturing industries are intensely competitive, and we face significant competition from a number of different sources. Several of our competitors have significantly greater name recognition as well as substantially greater financial, technical, product development and marketing resources than us.

We compete in all of our markets with other major healthcare, factory automation and small motor manufacturing related companies. Competitive pressures and other factors, such as new product or new technology introductions by us or our competitors may result in price or market share erosion that could have a material adverse effect on the our business, results of operations and financial condition. Also, there can be no assurance that our products and services will achieve broad market acceptance or will successfully compete with other products.

**Our quarterly results can fluctuate significantly from quarter to quarter which may negatively impact the price of our shares and/or provide significant variances in the prices at which such shares trade.**

Our revenues have fluctuated in the past, and may fluctuate in the future from quarter to quarter and period to period, as a result of a number of factors including, without limitation: the size and timing of orders from customers; the length of new product development cycles; market acceptance of new technologies; the extent and timing of eligible product returned for repair or replacement under warranty coverage; changes in pricing policies or price reductions by us or our competitors; the timing of new product announcements and product introductions by us or our competitors; the financial stability of major customers; our success in expanding our sales and marketing programs; acceleration or deferrals of customer orders and deliveries; changes in our strategy; personnel changes; and general market/economic factors.

Because a significant percentage of our expenses are relatively fixed, a variation in the timing of sales can cause significant fluctuations in operating results from quarter to quarter. As a result, we believe that interim period-to-period comparisons of our results of operations are not necessarily meaningful and should not be relied upon as indications of future performance. Further, our historical operating results are not necessarily indicative of future performance for any particular period.

Due to all of the foregoing factors, it is possible that in some future quarter(s), our operating results may be below the expectations of public market analysts and investors. In such event, the price of our Common Stock would likely be materially adversely affected.

**A substantial portion of our business is derived from our three core business areas which, if not serviced properly, may result in a material adverse impact upon our business, results of operations and financial condition.**

We currently derive a substantial part of our net revenues from sales of our medical device, motion control and small motor products and related services. We believe that a primary factor in the market acceptance of our product and services is the value that is created for our customers by those products and related services. Our future financial performance will depend in large part on our ability to continue to meet the increasingly sophisticated needs of our customers through the timely development, successful introduction and implementation of new and enhanced products and services. We have historically expended a significant percentage of our net revenues on product development and believe that significant continued product development efforts will be required to sustain our growth. Continued investment in our sales and marketing efforts will also be required to support future growth.

There can be no assurance that we will be successful in our product development efforts, that the market will continue to accept our existing products, or that new products or product enhancements will be developed and implemented in a timely manner, meet the requirements of our customers, or achieve market acceptance. If new products or product enhancements do not achieve market acceptance, our business, results of operations and financial condition could be materially adversely affected.

**We have recently violated certain credit facility covenants (and risk violating additional credit facility covenants in the future), which resulted in an event of default under our credit facilities and could have resulted in the acceleration of all amounts owing under all of our credit facilities, the loss of one or more of credit facilities and the need for us to seek alternative financing.**

Our credit facilities with our banks contain certain covenants concerning our financial performance. The failure to comply with any one or more of these covenants can result in an event of default, the acceleration of all amounts due, and the termination of each such credit facility. In addition, each of our credit facilities with Wells Fargo and Union Bank contain cross-default provisions that result in a default under one facility causing an immediate default under the other facility.

Historically, on those occasions on which we have failed to comply with our credit facility covenants, we have been granted waivers of the applicable covenants by our banks. Most recently, Wells Fargo Bank first agreed to forbear, and ultimately waived exercising its rights in connection with a default resulting from our violation of profitability covenants for the quarter ended March 31, 2009. Union Bank waived our violation of cash flow coverage covenant under the Union Bank credit facility for the year ended June 30, 2009.



The Wells Fargo forbearance was accompanied by a reduction by Wells Fargo in our line of credit from \$4 million to \$1 million during the forbearance period. A forbearance is not a waiver and Wells Fargo reserved its rights with respect to the default caused by the covenant violations during the forbearance period. During the forbearance period, Wells Fargo conducted a collateral audit and an analysis of our fixed assets to determine whether, and under what conditions, it might be willing to waive the then-existing covenant violations. All defaults under the credit facility for the quarter ended March 31, 2009 were ultimately waived and the credit facility was amended to maintain the availability of the line of credit at \$1 million. The terms of the line of credit were amended to include converting the availability to a borrowing amount based on eligible accounts receivable and inventory if the amounts borrowed exceeded \$500,000. Prior to the waiver, Wells Fargo had the right to exercise all of its rights and remedies under the credit facility, including its option to declare all amounts outstanding under the credit facility (which as of September 11, 2009 consists of approximately \$1,667,000 under the term loan component of the facility) immediately due and payable and, if not timely paid in full, foreclosing on substantially all of our assets in such amounts to satisfy the amount owing to them. We did not believe that we possessed sufficient cash on hand that would enable us to pay all amounts outstanding under the Wells Fargo facility should it exercise its right to declare all such amounts immediately due and payable.

The March 31, 2009 default under the Wells Fargo facility resulted in a cross-default under our Union Bank credit facility. We have received a waiver of this instance of the March 31, 2009 cross-default and a waiver of the June 30, 2009 cash flow coverage covenant violation from Union Bank. Either default, if not waived, could have caused the entire amount owing under the Union Bank facility (approximately \$1,552,000 as of September 11, 2009) to become immediately due and payable. As of September 11, 2009, there are no remaining un-waived covenant violations under either credit facility.

**The effects of the recent global economic crisis may impact our business, operating results or financial condition.**

The recent global economic crisis has caused a general tightening in the credit markets, lower levels of liquidity, increases in the rates of default and bankruptcy, and extreme volatility in credit, equity and fixed income markets. These macroeconomic developments could negatively affect our business, operating results or financial condition in a number of ways. For example, current or potential customers may be unable to fund purchases of our products, which could cause them to delay, decrease or cancel purchases of our products and services or to not pay us or to delay paying us for previously purchased products and services. In addition, financial institution failures may cause us to incur increased expenses or make it more difficult either to utilize our existing debt capacity or otherwise obtain financing for our operations, investing activities (including the financing of any future acquisitions), or financing activities (including the timing and amount of any repurchases of our common stock or debt we may make in the future). Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially and adversely affect our business, financial condition or operating results.

**The industry in which we operate is subject to significant technological change and any failure or delay in addressing such change could adversely affect our competitive position or could make our current products obsolete.**

The healthcare, factory automation and small motor markets are generally characterized by rapid technological change, changing customer needs, frequent new product introductions, and evolving industry standards. The introduction of products incorporating new technologies and the emergence of new industry standards could render the Company's existing products obsolete and unmarketable. There can be no assurance that we will be successful in developing and marketing new products that respond to technological changes or evolving industry standards.

New product development requires significant research and development expenditures that are ultimately funded by sales growth. Any significant decrease in revenues or research funding could impair our ability to respond to technological advances in the marketplace and to remain competitive. If we are unable, for technological or other reasons, to develop and introduce new products in a timely manner in response to changing market conditions or customer requirements, our business, results of operations and financial condition may be materially adversely affected.

In response to increasing market demand, we are currently developing new products and updating existing products. There can be no assurance that we will successfully develop these new products or that these products will operate successfully, or that any such development, even if successful, will be completed concurrently with or prior to the introduction of competing products. Any such failure or delay could adversely affect our competitive position or could make our current products obsolete.

**We face the risks and uncertainties that are associated with litigation against us which could have a material adverse effect on our business, results of operations and financial condition.**

We continually face the possibility of litigation as either a plaintiff or a defendant. It is not reasonably possible to estimate the awards or damages, or the range of awards or damages, if any, that we might incur in connection with such litigation. The uncertainty associated with potential litigation may have an adverse impact on our business. In particular, such litigation could impair our relationships with existing customers and our ability to obtain new customers. Defending or prosecuting such litigation may result in a diversion of management's time and attention away from business operations, which could have a material adverse effect on our business, results of operations and financial condition.

Many of our products are complex and technologically advanced. Such products may, from time to time, be the subject of claims concerning product performance and construction, including warranty claims. While we are committed to correcting such problems as soon as possible, there is no assurance that solutions can be found or found on a timely basis to satisfy customer demands and avoid potential claims or litigation. Such matters could have a material and adverse effect upon our business, results of operations and financial condition.

Due to the location of our facilities as well as our business activities, we may face the risk of litigation related to environmental remediation claims. Defending or prosecuting such litigation may result in a diversion of management's time and attention away from business operations, which could have a material adverse effect on our business, results of operations and financial condition even if we are ultimately found to be without fault.

There can be no assurance that such litigation will not result in liability in excess of our insurance coverage, that our insurance will cover such claims or that appropriate insurance will continue to be available to us in the future at commercially reasonable rates.

**We rely heavily on our proprietary technology which, if not properly protected or deemed invalid, could have a material adverse effect on our business, results of operations and financial condition.**

We are dependent on the maintenance and protection of our intellectual property and rely on exclusive development and supply agreements, confidentiality procedures, and employee nondisclosure agreements to protect our intellectual property.

There can be no assurance that the legal protections and precautions taken by us will be adequate to prevent misappropriation of our technology or that competitors will not independently develop technologies equivalent or superior to ours. Further, the laws of some foreign countries do not protect our proprietary rights to as great an extent as do the laws of the United States and are often not enforced as vigorously as those in the United States.

We do not believe that our operations or products infringe on the intellectual property rights of others. However, there can be no assurance that others will not assert infringement or trade secret claims against us with respect to our current or future products or that any such assertion will not require us to enter into a license agreement or royalty arrangement with the party asserting the claim.



**Our failure to manage growth could harm us by having a material adverse effect on our business and results of operations.**

We have in the past experienced periods of growth that have placed, and may continue to place, a significant strain on our resources. We also anticipate expanding our overall development, marketing, sales, management and training capacity as market demand requires. In the event we are unable to identify, hire, train and retain qualified individuals in such capacities within a reasonable timeframe, such failure could have a material adverse effect on us.

In addition, our ability to manage future increases, in the scope of our operations or personnel may depend on significant expansion of our research and development, marketing and sales, management, and administrative and financial capabilities. The ineffective management of expansion in the business could have a material adverse effect on our business, results of operations and financial condition.

**Our operations are dependent upon our key personnel. If such personnel were to leave unexpectedly, we may not be able to execute our business plan.**

Our future performance also depends in significant part upon the continued service of our key technical and senior management personnel, many of whom have been with us for a significant period of time. We maintain term key man life insurance policies for the CEO, the Executive Vice President who holds primary responsibility for Business Development, and the head of the Beaverton operations. Because we have a relatively small number of employees when compared to other leading companies in the same industry, our dependence on maintaining our relationship with key employees is particularly significant. We are also dependent on our ability to attract and retain high quality personnel, particularly in the areas of product development, operations management, marketing and finance.

A high level of employee mobility and the aggressive recruiting of skilled personnel characterize the healthcare and motion control industries. There can be no assurance that our current employees will continue to work for us. Loss of services of key employees could have a material adverse effect on our business, results of operations and financial condition. Furthermore, we may need to grant additional stock options to key employees and provide other forms of incentive compensation to attract and retain such key personnel.

**Our products may be subject to product liability legal claims which may cost us significant amounts in both money and management time and resources.**

We maintain insurance to protect against claims associated with the use of our products, but there can be no assurance that our insurance coverage will adequately cover any claim asserted against us. A successful claim brought against us in excess of our insurance coverage could have a material adverse effect on our business, results of operations and financial condition. Even unsuccessful claims could result in the expenditure of funds in litigation and management time and resources.

There can be no assurance that we will not be subject to product liability claims, that such claims will not result in liability in excess of our insurance coverage, that our insurance will cover such claims or that appropriate insurance will continue to be available to us in the future at commercially reasonable rates. Such claims could have a

material adverse affect on our business, results of operations and financial condition.

**Our evaluation of internal control and remediation of potential problems will be costly and time consuming and could expose weaknesses in financial reporting.**

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The regulations implementing Section 404 of the Sarbanes-Oxley Act of 2002 require management's assessment of the effectiveness of the Company's internal control over financial reporting beginning with our Annual Report on Form 10-K for the fiscal year ending June 30, 2009. In the future, our independent auditors will be required to confirm in writing whether management's assessment of the effectiveness of the internal control over financial reporting is fairly stated in all material respects, and separately report on whether they believe management maintained, in all material respects, effective internal control over financial reporting as of June 30, 2010. This process will be expensive and time consuming, and will require significant attention of management. Management can give no assurance that material weaknesses in internal controls will not be discovered. If a material weakness is discovered, corrective action may be time consuming, costly and further divert the attention of management. The disclosure of a material weakness, even if quickly remedied, could reduce the market's confidence in our financial statements and harm our stock price, especially if a restatement of financial statements for past periods is required.

**Our business and per share price may be adversely effected if material weaknesses in our internal controls are identified by ourselves or our independent auditors.**

Any weaknesses identified in our internal controls as part of the evaluation being undertaken by us and our registered independent public accountants pursuant to Section 404 of the Sarbanes-Oxley Act of 2002 could have an adverse effect on our business, and subsequently our per share price. We are in the process of evaluating and documenting our controls pursuant to Section 404 of the Sarbanes-Oxley Act. We are working toward being fully compliant with the requirements of Section 404 of the Sarbanes-Oxley Act at the time it applies to us. Failure to comply could have a material adverse affect on our business, per share price, financial condition, and our ability to remain listed as a publicly held exchange traded company.

**The failure to raise the market price of our common stock may affect our ability to remain a publicly-traded company.**

The minimum bid price for our publicly traded common stock has remained below \$1.00 for a significant period of time during late 2008 and throughout 2009. Although Nasdaq had suspended its minimum bid requirement in October 2008, Nasdaq lifted that suspension on August 3, 2009 and we again face a delisting deadline date of January 7, 2010. If the minimum bid price for our stock does not rise above \$1.00 for the requisite number of days prior to such deadline or if we fail to meet any other listing requirement of the Nasdaq Capital Market, our common stock may be delisted from the Nasdaq Capital Market, which could negatively affect the value of our common stock. On January 9, 2009, our shareholders authorized us to engage in a reverse split of our Common Stock which may, as a result of

increasing our per share price above \$1.00, provide us the means to avoid delisting. As the delisting deadline approaches and if the market price of our shares remains below \$1.00, our Board of Directors will continue its review of the advisability of proceeding with a reverse split of our Common Stock or other appropriate actions.

**We are subject to changes in and interpretations of financial accounting matters that govern the measurement of our performance, compliance with which could be costly and time consuming.**

We are subject to changes in and interpretations of financial accounting matters that govern the measurement of our performance. Based on our reading and interpretations of relevant guidance, principles or concepts issued by, among other authorities, the American Institute of Certified Public Accountants, the Financial Accounting Standards Board, and the United States Securities and Exchange Commission, our management believes our performance, including current sales contract terms and business arrangements have been properly reported. However, there continue to be issued interpretations and guidance for applying the relevant standards to a wide range of contract terms and business arrangements that are prevalent in the industries in which we operate. Future interpretations or changes by the regulators of existing accounting standards or changes in our business practices could result in future changes in our accounting policies and practices that could have a material adverse effect on our business, financial condition, cash flows, revenue and results of operations.

**A substantial portion of our revenue is derived from a small number of customers such that if we were to lose one, it could have a material and adverse effect on our business, financial condition and results of operations.**

We have few significant customers that contribute a significant portion of our revenue. Our loss of one or more of such customers could severely impact us, including a material adverse effect on our business, financial condition, cash flows, revenue and results of operations.

#### **Item 1B. Unresolved Staff Comments**

None

#### **Item 2. Description of Property**

Our executive offices and Irvine manufacturing facility are located at 2361 McGaw Avenue, Irvine, California 92614. We lease the 28,000 square foot facility from an unrelated third party at a base monthly lease rate of \$36,000 through April 2018, with an option to terminate early in April 2015. The building is a one-story stand-alone building of concrete tilt-up construction, approximately 25 years old and in good condition. This facility was occupied in April, 2008 at the lease termination of the prior 18,000 square foot facility at 151 East Columbine Avenue, Santa Ana, California 92707.

Our Beaverton office and manufacturing facility is located at 15201 N.W. Greenbrier Parkway, B-1 Ridgeview, Beaverton, Oregon 97006. The Company leases the 7,500 square foot facility from an unrelated third party, at a base monthly lease rate of \$6,300 through April 2014. The building is a one-story suite in a 20-year-old industrial office complex and in good condition. This facility was occupied in January, 2008 at the lease termination of the prior 11,000 square foot facility at 1800 N.W. 169<sup>th</sup> Place, Building C100, Beaverton Oregon 97006.

Our Carson City office and manufacturing facility is located at 2950 Arrowhead Drive, Carson City , Nevada 89708. We purchased 4.4 acres of real property and a 20,000 square foot industrial building and related improvements at this location for \$2,200,000 in March 2006. The building is a two-story building of concrete block construction and in

good condition. The purchase was financed with cash on hand and by a 10 year Promissory Note and related Loan Agreement with Union Bank, whereby we borrowed \$1,650,000. This loan is secured by the land and building in Carson City, Nevada.

We believe that the base monthly rental rates on the leased facilities are comparable to rents charged for comparable properties in the market area. The current facilities are believed to be adequate for our expected needs. We believe there is full compliance with applicable state and EPA and other agency environmental standards at each facility.

**Item 3. Legal Proceedings**

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On June 23, 2008, the Orange County Water District ( OCWD ) filed a complaint in the Superior Court of the State of California in the County of Orange concerning remediation of alleged ground water contamination in the Orange County Groundwater South Basin; Orange County Water District v. Sabic Innovative Plastics U.S. LLC, et al., Case No. 00078246. The South Basin underlies parts of Santa Ana, California and adjacent cities. The complaint identifies 17 named defendants, including Pro-Dex, and also designates 400 unnamed Doe defendants. We moved out of this Santa Ana site in April, 2008 and have no remaining operations there.

The complaint alleges that the defendants contaminated the South Basin with volatile organic chemicals ( VOCs ) and perchlorate through various activities at properties each defendant now controls or has controlled in the past. Through its lawsuit, the OCWD seeks compensatory relief for all its own remedial activities, and injunctive relief to compel the defendants to undertake remedial activities in general. The complaint does not, however, specify any remedial activities that the OCWD has undertaken to date or any remedial activities that it seeks any particular defendants to undertake. Moreover, from our investigation of OCWD s remedial activities to date, we have determined that the OCWD is in the early stages of its remedial investigation for the South Basin groundwater contamination.

As noted above, 16 other entities are named defendants in this case along with Pro-Dex. While some are small businesses, others are larger corporations or their subsidiaries. Further, as this case progresses, the OCWD is likely to add at least a few more named defendants to the case from the 400 Doe defendants it has designated in the current complaint. In the indeterminable event that we would be held liable in the case, OCWD s total recovery probably would be allocated among several defendants, each of which would pay only a proportionate share of that total recovery.

One of our past insurers has committed to pay most of our defense costs for the lawsuit, while reserving its rights as to whether it will cover any damages awarded against us, or any settlement payment to which Pro-Dex agrees to resolve the lawsuit, under past policies issued to us for a three-year period, March 31, 1983 to March 31, 1986. The policies for these three years have occurrence payment limits of \$500,000 for each annual term.

Overall, the OCWD complaint remains vague, the OCWD is in an early stage of its remedial activities in the South Basin, the lawsuit is in the early stages of discovery, one of our insurers has committed to pay most defense costs and has reserved rights under one three-year set of policies and is continuing to consider extending coverage to us under other past policies, and any recovery the OCWD may gain through the lawsuit is likely to be allocated among several defendants. Therefore, our liabilities, as well as our costs of defending, monitoring and concluding our involvement in this case are uncertain, and those costs cannot now be estimated.

In general, we are from time to time a party to various legal proceedings incidental to our business, other than the above, none of which we consider may be material at this time. There can be no certainty that we may not ultimately incur liability or that such liability will not be material and adverse.

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

No matter was submitted to a vote of our shareholders during the fourth quarter ended June 30, 2009.

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**PART II****Item 5. Market For Common Stock, Related Shareholder Matters and Issuer Purchases of Equity Securities**

Our common stock, no par value, is quoted under the symbol "PDEX" on the automated quotation system of the Nasdaq Capital Market ("NASDAQ"). The following table sets forth for the quarters indicated the high and low sales prices as reported by NASDAQ. The quotations reflect inter-dealer prices, without retail markup, markdown, or commissions, and may not necessarily represent actual transactions. On September 11, 2009, the last sale price of our common stock as reported by NASDAQ was \$0.48 per share.

| <b>Quarter Ended</b> | <b>High</b> | <b>Low</b> |
|----------------------|-------------|------------|
| September 30, 2007   | 1.94        | 1.36       |
| December 31, 2007    | 1.55        | 1.32       |
| March 31, 2008       | 1.71        | 1.43       |
| June 30, 2008        | 1.70        | 1.01       |
| September 30, 2008   | 1.13        | 0.80       |
| December 31, 2008    | 0.95        | 0.35       |
| March 31, 2009       | 0.50        | 0.27       |
| June 30, 2009        | 0.50        | 0.35       |

At June 30, 2009, there were approximately 253 holders of record of our common stock. This number does not include beneficial owners including holders whose shares are held in nominee or "street" name.

We have not paid a cash dividend with respect to our common stock, and do not intend to pay cash dividends in the foreseeable future. The current policy of our Board of Directors is to retain earnings to provide funds for the operation and expansion of the business. The Board of Directors, in light of the circumstances then existing, including our earnings and financial requirements and general business conditions, will determine future dividends, if any. There are restrictions associated with our credit facilities on the Company issuing dividends.

**Equity Compensation Plan Information**

| As of June 30, 2009<br><br>Plan Category | 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 Available for Issuance Under Equity Compensation Plans (excluding securities reflected in column (a)) |
|--|---|---|--|
|  | (a)   | (b)   | (c)  |
| Plans Approved by Stockholders           | 1,018,500   | \$1.42  | 552,545  |
| Total                                    | 1,018,500   | \$1.42  | 552,545  |

In September 2002, our Board of Directors authorized the repurchase on the open market of up to 500,000 shares of our outstanding Common Stock at a share price no greater than \$1.25, subject to compliance with applicable laws and regulations. There is no requirement that we repurchase all or any portion of such shares. The maximum total value of the repurchase is not to exceed \$500,000. From the inception of the repurchase authorization through the fiscal year-end date of June 30, 2003, we repurchased 75,700 shares of Common Stock for \$43,741, at an average price of \$0.58 per share. No additional shares were repurchased in fiscal years 2004 through 2008. During fiscal year 2009, we repurchased 219,695 shares of common stock for \$133,472, at an average price of \$0.61 per share. Since the initiation of the buyback program in 2002 through June 30, 2009, we have repurchased 295,395 shares for \$177,213 at an average price of \$0.60 per share. Our Board suspended the buyback authorization in May 2009 and has not set a reinitiation date for the purchase of our shares pursuant to this program.

#### **Item 6. Selected Financial Data**

Not Required.

#### **Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion and analysis provides information that management believes is relevant to an assessment and understanding of the Company's results of operations and financial condition for each of the two years ended June 30, 2009 and 2008, respectively. This discussion should be read in conjunction with the Consolidated Financial Statements and the Notes thereto included elsewhere in this Report. This Report contains certain forward-looking statements and information. The cautionary statements included herein should be read as being applicable to all related forward-looking statements wherever they may appear. Our actual future results could differ materially from those discussed herein.

## Critical Accounting Estimates and Judgments

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States ( GAAP ). The preparation of our financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosures. We base our estimates on historical experience and 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. The significant accounting policies that are believed to be the most critical to fully understanding and evaluating the reported financial results include revenue recognition, warranty reserve, inventory valuations for slow moving items, impairment of goodwill, and the recovery of deferred income tax assets.

We recognize sales and associated cost of sales, upon shipment, FOB origin. There have been minimal returns for credit, so no reserve for product returns has been established.

We determine our inventory value at the lower of cost (first-in, first-out method) or market value. We determine a reduced market value of our inventory based on the age of inventory on hand. We define aging of inventory as inventory that exceeds an estimated 12 months of usage and exceeds orders on hand.

We determine the reserve for our accounts receivable by examining the aging of the receivables. We define aging of receivables as time passed since the sale was completed, revenue was recognized and the receivable was established. If the receivable is aged over 90 days old, or has a known collection risk, it is reserved from 10% of its value up to 100%. The actual amount reserved may vary depending on account credit and collection history.

The warranty accrual is determined by reviewing the return rates and warranty repair costs for warranty-eligible products. We accrue an amount of expected repair cost based on these factors projected for the remaining applicable warranty period. If actual return rates or repair costs differ from our estimates, warranty expense could vary from the projected accrual. The repair return rates and cost assumptions are reviewed quarterly. The potential return amount is based on historical return and repair cost data. At June 30, 2009 we had \$518,000 in accrued warranty reserves, as compared to \$861,000 in accrued warranty reserves at June 30, 2008. The decrease is due to lower shipment levels in the warranty-eligible product line in 2009 as compared to 2008, coupled with lower assumed return rates and lower assumed costs to repair returned product.

In accordance with Statement of Financial Accounting Standards ( SFAS ), SFAS No. 144, Accounting for the Impairment or Disposal for Long-Lived Assets ( SFAS 144 ) long-lived assets and intangible assets with definite lives are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Impairment indicators include, among other conditions, cash flow deficits, historic or anticipated declines in revenue or operating profit and adverse legal or regulatory developments. If it is determined that such indicators are present and the review indicates that the assets will not be fully recoverable, based on undiscounted estimated cash flow over the remaining amortization periods, their carrying values are reduced to estimated fair market value. Estimated fair market value is determined primarily using the anticipated cash flow discounted at a rate commensurate with the risk involved. For the purposes of identifying and measuring impairment, long-lived assets are grouped with other assets and liabilities at the lowest level for which identifiable cash flow are largely independent of the cash flow of other assets and liabilities. The triggering event is explained in further detail in note 10 of the Notes to the Financial Statements. Our standard annual impairment testing is done April 1 of each year.

We monitor current market conditions and review for potential triggering events quarterly to determine if there is a need for interim impairment testing. We did not determine that a triggering event for the Astromec and Micro Motors goodwill occurred in the past 12 months. We did however; determine that a triggering event occurred with the patent intangible asset.

In determining if a triggering event has occurred, we consider not only expectations for growth in the entire US economy, but also expectations for regional growth specific to our sales markets and specific to our industry and product lines. While our operating units are influenced by changes in the general economic outlook of the United States, they are most heavily influenced by changes specific to the medical device industry. Furthermore, the magnitude of economic changes within the industry is viewed alongside the outlooks and forecasts specific to the reporting units to obtain a better sense of the likelihood that goodwill may be impaired. Declines within the industry s outlook are reflected in the unit s revenue projections.

We identify two reporting units for purposes of our annual goodwill impairment testing arising from its acquisitions of Micro Motors and Astromec. In accordance with SFAS No. 142, goodwill is not amortized and is assessed annually for impairment (as of April 1) or whenever events or changes in circumstances indicate that the carrying value of such assets may not be recoverable. Our Carson City reporting unit corresponds to the operations resulting from the Astromec acquisition, while our Irvine reporting unit corresponds to the operations resulting from the Micro Motors acquisition. Our intangible asset is related to the interosseous patents associated with the Intraflow acquisition.

Goodwill and Intangible assets are tested for impairment using a discounted cash flow analysis. The discounted cash flow analysis relies upon estimates of the entity's future revenue and expenses to ultimately project the future cash flows resulting from the business activity of each entity. The projected future cash flows are discounted to present value at an appropriate discount rate. An appropriate discount rate is reached by calculating the weighted average cost of capital (WACC), which is determined by the assumptions underlying the Capital Asset Pricing Model (CAPM) and is considered to reflect the view of Market Participants, as required under SFAS 157. The inputs used in calculating the WACC are described below.

- a. The assumed capital structure is based upon the Company's actual capital structure and debt to equity ratio at the time of analysis.
- b. The cost of debt is based on the Company's actual contracted rates.
- c. The cost of equity is equal to the risk free rate represented by the 10 year Treasury note, plus the Company's historical correlation to market movement  $\beta$  times the historical equity risk premium, plus an additional small stock premium.
- d. In valuing the Company's patents, an additional risk premium is added to reflect the increased risk inherent in intangible assets.
- e. Also in valuing the patents, an expected value calculation was performed that weighted the values of different scenarios based on their expected probability of occurrence.

We performed separate calculations to determine the sensitivity of our intangible asset impairment conclusions to increases in the assumed discount rates. In the case of Astromec, the goodwill impairment test is not failed until the discount rate is increased to 33 percent. In the case of Micro Motors, the goodwill impairment test is not failed until the discount rate is increased to 240 percent.

Additionally, the material assumptions relied upon in the discounted cash flow analysis used to value the Company's Intraflow patents are shown below.

- a. The patent is valued from the perspective of Market Participants, which are believed to possess sales and marketing expertise in the dental and medical device field. Management's financial analysis of the intangible asset was performed from the perspective of a potential acquirer and estimates what a Market Participant would be willing to pay for the asset. This methodology is consistent with FAS 157 requirements for Fair Value estimates to be estimates of the price that would be received to sell an asset, or an Exit Price. In these scenarios, the patents' value is based on the assumed greater distribution capabilities and lower incremental costs that would be held by Market Participants.
- b. The patent was also valued as a ongoing product line without any additional distribution partner or Market Participant value.
- c. A premium for the increased riskiness of intangible assets was included in the asset's discount rate.

- d. We performed separate calculations to determine the sensitivity of the asset's impairment conclusion to variances in sales growth, gross margin, and discount rate. Sales growth forecasts ranged from growth of 6 times to 12 times 2008 levels.
- e. There were transaction and/or start-up costs associated with the Market Participants valuation.

The material assumptions relied upon in the discounted cash flow analysis used to value the goodwill held in the Carson City reporting unit are shown below.

- a. Goodwill resulting from the Company's acquisition of Astromec is tested for impairment under its Carson City motor manufacturing operations.
- b. Motor sales of existing products are assumed to decline as products age, but are more than replaced by revenue growth from new products and increased intercompany sales for medical hand piece products.
- c. The existing fixed cost structure of the motor manufacturing operations will be better absorbed by the higher forecasted volume of production, resulting in increased profit margins.



d. In addition to the value of the goodwill held in the Carson City reporting unit as if it stands alone, an additional analysis is performed to estimate a value to Pro-Dex of having an in-house motor manufacturer for the medical device product line. This captive capability enables development speed and focus, which produces revenue in other operating units.

e. The value of the Carson City manufacturing operation is added to the value of the additional capability provided to Pro-Dex for the total value of the goodwill.

The material assumptions relied upon in the discounted cash flow analysis used to value the goodwill held in the Micro Motors reporting unit are shown below.

a. Goodwill resulting from the Company's acquisition of Micro Motors is tested for impairment under its Irvine reporting unit, which houses the operations resulting from the base technology acquired from Micro Motors.

b. Sales to existing customers are assumed to decline, but are more than replaced by revenue growth from new customers.

The existing fixed cost structure of the Irvine operations will be better absorbed by the higher forecasted volume of medical products, resulting in increased profit margins.

Given the company's lack of a direct dental distribution channel, it has stopped actively promoting the product based on the intangible asset resulting from the purchase of certain assets from IntraVantage, Inc. in October 2005. Any substantial future value therefore stems from the possibility that a company with a direct dental distribution channel (a Market Participant) might be interested in access to the technology through product purchases, licenses, acquisition, joint venture, or other means. Given the current economic environment, the general lack of investment in new products, the limited number of Market Participants to whom this technology relates, the time and expense necessary to consummate a transaction, and other factors considered by management, there is also a significant possibility that no distribution partner will be found, resulting in effectively no value of the asset. Given this change in circumstance, in accordance with FAS 144 Accounting for the Impairment or Disposal of Long-Lived Assets, management tested the carrying amount of the intangible asset for recoverability as of March 31, 2009. The result of management's analysis based on several scenarios (with varying probability of occurring) was that the asset's expected value at that date was \$150,000 and, accordingly a charge of \$997,280 was taken in the fiscal 2009 third quarter. The asset continued to amortize its remaining value over the remaining patent's life. As to June 30, 2009, the patent's intangible

carrying value was \$147,000. Management remains committed to optimizing the value of this technology for our shareholders, and will continue to pursue any opportunity to accomplish that end.

For the Astromec reporting unit's impairment testing there was an assumption of decreased external sales growth compared to 2008, which was more than offset by an increased sales growth rate of motors for internal (Pro-Dex) use. In addition to the value of the reporting unit as an internal supplier and stand alone business, the unit has additional strategic value by enabling Pro-Dex to gain additional customers under other reporting units that is considered in the valuation. It should be noted that the unit passes its goodwill impairment test without the inclusion of this additional enablement value.

For the Micro Motors reporting unit's impairment testing, there was an assumption of a slower than historical sales growth rate than in the previous valuation. The total 5 year growth rate in the 2008 valuation was equal to the historical 5 year growth rate of the Company, but the growth rate was reduced by 50% for the 2009 valuation. The reason for the reduced sales growth is the current and forecast near and medium term market conditions. The effect of this sales growth decrease was to decrease the unit's calculated value, but not to an extent that it fails the goodwill impairment test. The computed reporting unit value exceeds the carrying value of the unit by more than 100 percent.

We are subject to the revised requirements of the Statement of Financial Accounting Standards ( SFAS ) No. 123 (R) *Accounting for Stock-Based Compensation* as revised December 2004. This standard establishes the accounting standards for equity compensation, and applies to us in the recognition of the cost of stock options awarded based on the grant-date fair value of those awards

As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating the actual current tax liabilities together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within the consolidated balance sheet. The most significant tax assets are future deductions from the amortization of intangibles over the next ten years, inventory reserves and net operating loss carry forwards. Tax assets also result from net operating losses and research and development tax credits. We must then assess the likelihood that the deferred tax assets will be recovered from future taxable income and, to the extent we believe that recovery is not likely, a valuation allowance must be established. To the extent we establish a valuation allowance or increase or decrease this allowance in a period, the impact will be included in the tax provision in the statement of operations.

Significant management judgment is required in determining our provision for income taxes and the recoverability of our deferred tax asset. Such determination is based primarily on our historical taxable income, with some consideration given to our estimates of future taxable income by jurisdictions in which we operate and the period over which our deferred tax assets will be recoverable. Due to cumulative taxable losses during the past three years, we recorded \$2,241,000 valuation allowance against our deferred tax assets in the year ended June 30, 2009. This reduction in deferred tax assets is adjusted through income tax expense.

As a company with a very small market capitalization and a limited shareholder base, our market capitalization has been negatively affected by the very unusual economic and market environment of late. We believe our market capitalization may not reflect the true value of the Company and or be indicative of the true economic value of our assets. Some of the indications of disproportionate effect on our company include studies that show a strong difference in the valuations of the companies based on total market capitalization, with the small caps being most adversely affected. One recent study [The Bi-Weekly Fusion: Orthopedic Company Update by SMH Capital, for the two weeks ended February 13, 2009] examined valuation metrics for orthopedic and medical device companies. The companies classified as Large Cap are trading at 70% of their 52 week high, 2.4 times revenues and 7.9 times EBITDA. The 15 companies classified as Mid-Caps were as expected, in the middle of the trading multiple, trading at 54% of their 52 week high, 1.5 times revenues and 8.2 times EBITDA, Small Cap companies are trading at 29% of their 52 week high, 1.5 times revenues and 11.4 times EBITDA. The EBITDA multiple can be misleading for the small caps as of the 15 companies in the sample size, only four had a positive EBITDA, of which Pro-Dex was one. Of the large caps, all seven companies exhibited a positive EBITDA. In an updated study [The Bi-Weekly Fusion: Orthopedic Company Update by SMH Capital, for the two weeks ended June 19, 2009], Large-Caps and Mid-Caps were trading at 64% of their 52 week high and Small-Caps were trading at 40% of their all time high. We feel these analyses confirm that the current market environment exhibits a significant disproportionately unfavorable effect against small public companies in general, including Pro-Dex.

## **Year in Review**

Fiscal year 2009 was a difficult year for the world's economy and Pro-Dex was not immune to its effects. Our consolidated sales for 2009 declined by 16% as compared to 2008, and approximately even with 2007 sales levels. Over the longer term, we maintained a cumulative average growth rate of almost 10%/year since fiscal year 2003. The motion control business was particularly adversely affected as our high margin products associated with this business are used by capital equipment providers, and these orders came to a sudden standstill in our third quarter (Jan-March 2009). This part of the business remained low in the subsequent quarter, and there are no indications yet for a strong structural resumption of business to previous levels. In response to the adverse environment for these products, we sensed an opportunity to gain market share and added additional sales resources in January to aggressively pursue new customers and new sales channels. The medical products also had a year-over-year decline, as the 2008 sales were high due to two major product launches that were not repeated in 2009. As the economy stalled, so did our customers' appetite for new projects. We continued the work on two of the major development projects initiated last year, and expect to see new revenue from them in fiscal year 2010 and beyond. In spite of the sales decline, our backlog of orders remains relatively flat, down by 6% compared to the end of last year.

We initiated strong responses to the top-line sales decline, and reduced our associate headcount by 10% since the end of fiscal year 2008. Our efforts to improve our product quality began to show benefits in fiscal year 2009 and warranty cost was reduced by over 50% from \$1.3 million in fiscal year 2008 to \$664 thousand in fiscal year 2009. Our operating costs in fiscal year 2009 (including a non-cash impairment expense of \$997,000) were \$8.2 million up 6% over the prior year's expenses of \$7.8 million. In addition, we consolidated the management and business development efforts of our Carson City operations with those at Irvine. The cost savings introduced by this move allowed for additional investment in developing new motor technology and accelerate the improvements in this part of the business. There were one-time costs associated with these transitional actions, and the actions were phased through the year, but our basic cost structure was improved to better match the lower sales levels.

The new facilities for both our Beaverton and the Southern California operations have met our expectations. They are providing for more conducive facilities for engineering, development, and production efforts and contributing to efficiencies gained through collaborative workspaces. The Irvine space has allowed us to in-source much of our previously outsourced machining work, which in addition to providing better utilization of the facility, has proven to add to our competitive advantage in responding quickly to our customer's needs.

Combined with the lower sales levels, our net income was negatively affected by two large non-cash charges realized in our third quarter that resulted in a large loss for the year. First, due to our inability to find a distribution partner for our Intraflow products, we realized a \$997 thousand pre-tax impairment loss from writing down the value of the associated patent. We are not actively marketing the product, but continue the search for a distribution partner to help realize the product's full potential. The second charge was a \$2 million tax allowance reducing the book value of our deferred tax assets. We decided to take this allowance as the recent history of the Company's taxable income, especially in consideration of the intangible write-off, made the near-term realization of the deferred tax assets less assured.

We maintained the Company's strong financial position by generating over \$1.7 million in operating cash for the 2009 fiscal year, in addition to the \$2.0 million generated the prior year. Our net debt was reduced by over 33% to \$2.2 million from \$3.5 million at the end of 2008. Due to the reported GAAP losses, the terms of our credit facility were reduced to allow for \$1 million of borrowing on our credit line. This is a significant reduction in availability, but we have not had any amounts borrowed under the facility since early in calendar 2009 and ended the year with over \$1.1 million in cash on hand, so the reduction has had no effect on operations to date.

Entering 2010, we have a lower cost structure, greatly improved legacy product performance, two major product launches in the pipeline and a stable backlog. We remain committed to return the Company to profitable operations and providing a higher level of earnings in the coming years. We continue to drive costs out of the business and

reliably design products that exceed our customers' expectations. As the economy becomes stronger, we anticipate that more customers will be launching new products again and we will participate in some of those launches. We also look forward to the markets for capital equipment products improving and our motion control top line returning to more normal levels.

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## Results of Operations

### Results of Operations for Fiscal Year Ended June 30, 2009, Compared to Fiscal Year Ended June 30, 2008

The following table sets forth financial data and the percentage of net revenues regarding the Company's financial position and operating results.

| (In Thousands)                               | Fiscal Year ended June 30, |       |           |      |
|--|----------------------------|-------|-----------|------|
|  | 2009                       |       | 2008      |      |
| Net sales:                                   | \$ 21,122                  | 100%  | \$ 25,126 | 100% |
| Cost of sales                                | 14,374                     | 68%   | 16,917    | 67%  |
| Gross Profit                                 | 6,748                      | 32%   | 8,209     | 33%  |
| Selling, general and administrative expenses | 4,452                      | 21%   | 5,021     | 20%  |
| Intangible Impairment                        | 997                        | 5%    | -         | -    |
| Research and development costs               | 2,791                      | 13%   | 2,732     | 11%  |
| Income (Loss) from Operations                | (1,492)                    | (7%)  | 456       | 2%   |
| Net interest (expense) and net other income  | 212                        | 1%    | 138       | 1%   |
| (Benefit) / Provision for Income Taxes       | (1,100)                    | (5%)  | 1         | 0%   |
| Allowance for deferred tax asset             | 2,241                      | 11%   | -         | 0%   |
| Net Income (Loss)                            | \$ (2,845)                 | (13%) | \$ 317    | 1%   |

**Net Sales.** Consolidated sales decreased 16% or \$4,004,000 to \$21,122,000 from \$25,126,000 for 2009 as compared to 2008. Medical sales were lower by \$3,014,000 or 21%, due to lower sales to our two largest customers by \$1,742,000 driven by a return to stable shipping levels to these two customers after their previous year's inventory build. Shipments to dental customers decreased by \$670,000 or 20% as we strategically reduced sales of certain low profit products. Sales to industrial customers decreased by \$169,000 or 25% reflecting a slowdown in our motion control business. Sales related to government research related products and product repairs were up with a year over year increase of \$270,000 due primarily to an increase in repair and upgrade work for products that were not warranty eligible which offset the decline in government agency related work. Aerospace sales were up \$242,000 or 10% due to higher commercial aircraft motor shipments.

Although selective price increases and decreases were implemented in response to market conditions, the majority of the sales growth and declines for each product line is due primarily to changes in sales volume, not the effect of price changes.

The amount of Pro-Dex total sales to each customer type and the year-to-year change is noted in the table below:

| Sales by customer type (\$'000) | Fiscal Year ended June 30, |           | Increase/<br>(Decrease) |
|---------------------------------|----------------------------|-----------|-------------------------|
|                                 | 2009                       | 2008      |                         |
| Dental                          | \$ 2,620                   | \$ 3,290  | (20%)                   |
| Medical                         | 11,107                     | 14,121    | (21%)                   |
| Industrial                      | 2,448                      | 3,279     | (25%)                   |
| Aerospace                       | 2,624                      | 2,382     | 10%                     |
| Government research and other   | 2,324                      | 2,054     | 13%                     |
| Total Sales                     | \$ 21,122                  | \$ 25,126 | (16%)                   |



**Gross Profit and Gross Profit Percentage of Sales.** Our consolidated gross profit for 2009 decreased \$1,461,000 or 18% compared to the gross profit in the previous year due to the lower medical, dental and industrial product sales volume. Gross profit as a percentage of sales decreased to 32% for the year ended June 30, 2009 compared to 33% for the year ended June 30, 2008. Gross margin as a percentage of sales was negatively impacted as a less favorable sales mix that included a lower amount of high margin industrial motion control and medical products that did not completely offset the favorable effect of reduced warranty costs. Gross profit and gross profit as a percentage of sales were as follows:

|                                  | Fiscal Year ended June 30, |              | Decrease |
|----------------------------------|----------------------------|--------------|----------|
|                                  | 2009                       | 2008         |          |
| Gross Profit                     | \$ 6,748,000               | \$ 8,209,000 | (18%)    |
| Gross Profit Percentage of Sales | 32%                        | 33%          |          |

**Selling, General and Administrative Costs (S, G&A).** S, G & A expenses (including a \$997,000 intangible impairment charge) increased 9% to \$5,449,000 for the year ended June 30, 2009 from \$5,021,000 for year ended June 30, 2008. We had a 13% decrease in selling expense mainly due to reduced labor expenditures, advertising and tradeshow activity. General and administrative costs were lower by 11% due to labor cost reductions associated with reduced headcount. The increase in total G & A costs was due to the impairment cost of the patent related intangible (\$997,000). The impairment loss is more fully described in Note 9 of the accompanying Consolidated Financial Statements.

As a percentage of sales, S, G&A costs, this in 2009 included \$997,000 in asset impairment expense, increased to 26% from 20% for the year ended June 30, 2009 and 2008, respectively. S, G&A costs were as follows:

|  | Fiscal Year ended June 30, |              | Increase<br>(Decrease) |
|--|----------------------------|--------------|------------------------|
|  | 2009                       | 2008         |                        |
| Selling  | \$ 1,295,000               | \$ 1,482,000 | (13%)                  |
| General and administrative   | \$ 3,157,000               | \$ 3,539,000 | (11%)                  |
| Impairment of intangible asset                                     | \$ 997,000                 | \$ -         | N/A                    |
| Total Selling, General & Administrative cost                       | \$ 5,449,000               | \$ 5,021,000 | 9%                     |
| Selling, General & Administrative cost as a<br>Percentage of Sales | 26%                        | 20%          |                        |

**Research and Development Costs.** Company-funded research and development expenses increased \$59,000 to \$2,791,000 for the year ended June 30, 2009 from \$2,732,000 for the year ended June 30, 2008, an increase of 2%. The increase was primarily due to increased motor development and labor costs. Company-funded research and development costs were as follows:

|   | Fiscal Year ended June 30, |              |          |
|---|----------------------------|--------------|----------|
|   | 2009                       | 2008         | Increase |
| Research and Development (R&D) Costs                    | \$ 2,791,000               | \$ 2,732,000 | 2%       |
| Research and Development costs as a Percentage of Sales | 13%                        | 11%          |          |

**Operating Profit (loss) and Operating Profit (loss) as a Percentage of Sales.** Our consolidated operating loss for the year ended June 30, 2009 was \$1,492,000 compared to an operating profit of \$456,000 for the year ended June 30, 2008. Operating profit as a percentage of sales decreased to -7% for the year ended June 30, 2009 compared to 2% for the year ended June 30, 2008. Operating profit and margin were as follows:

|  | Fiscal Year ended June 30, |            |            |
|--|----------------------------|------------|------------|
|  | 2009                       | 2008       | (Decrease) |
| Operating Profit (Loss)                          | \$ (1,492,000)             | \$ 456,000 | N/A        |
| Operating Profit (Loss) as a Percentage of Sales | (7%)                       | 2%         |            |

**Royalties and Other Income.** We earned and received \$14,000 in royalty payments in fiscal year 2009, compared to \$35,000 in royalty payments in 2008. We had no other expense during the year ended June 30, 2009 compared to \$9,000 in other expense for asset abandonment associated with the move during the year ended June 30, 2008.

**Net Interest Income/Expense.** Net interest expense was \$226,000 in the year ended June 30, 2009, which included \$228,000 in interest expense offset by \$2,000 in interest income, compared to \$164,000 which included \$181,000 in interest expense offset by \$17,000 in interest income, in the prior year.

The increase in interest expense is due to higher borrowing requirements, due to a full year of interest expense associated with the Irvine facility tenant improvement loan. Included in the \$164,000 in 2008 is \$15,000 in accrued interest relating to the completed IRS examination for the tax years ending June 30, 2004, 2005 and 2006.

|   | Fiscal Year ended June 30, |             | Increase/<br>(Decrease) |
|---|----------------------------|-------------|-------------------------|
|   | 2009                       | 2008        |                         |
| Debt related interest expense             | \$ 228,000                 | \$ 166,000  | 37%                     |
| IRS exam related interest                 | \$ -                       | \$ 15,000   | (100%)                  |
| Total interest expense                    | \$ 228,000                 | \$ 181,000  | 26%                     |
| Interest income                           | \$ (2,000)                 | \$ (17,000) | (88%)                   |
| Net interest expense                      | \$ 226,000                 | \$ 164,000  | 38%                     |
| Interest expense as a Percentage of Sales | 1%                         | 1%          |                         |

**Income Tax Provision.** Our estimated effective combined federal and state tax rate on loss from operations for the year ended June 30, 2009 resulted in a 67% provision of the loss before tax compared to a 0.1% provision of earnings before tax for the year ended June 30, 2008. The difference in the 2009 rate is due to a \$2,241,000 valuation allowance against our current and long term deferred tax assets. The deferred tax valuation allowance is more fully described in Note 5 of the accompanying Consolidated Financial Statements.

During the year ended June 30, 2009, the Internal Revenue Service settled its audit of our federal income tax returns for the fiscal years ended June 30, 2004 through June 30, 2006. This settlement resulted in the reversal of \$41,000 of unrecognized tax benefits associated with Section 263A costs we previously reported, which reduced our tax expense by \$6,000. During the year ended June 30 2009, we filed amended state returns for the fiscal years ended June 30, 2004 through June 30, 2006 to report the related changes to the Section 263A costs. The filing of the amended state tax returns resulted in the reversal of \$9,000 of unrecognized tax benefits associated with the Section 263A costs we reported, which reduced our tax expense by \$1,000. Our remaining liability for uncertain tax positions, related to the fiscal years ended June 30, 2005 through June 30, 2009, is \$54,000 as of June 30, 2009. We have not identified any new unrecognized tax benefits.

As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax liabilities together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. The deferred tax assets result primarily from tax basis of intangible assets in excess of book basis. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent management believes that recovery is not likely, we must establish a valuation allowance. To the extent a valuation allowance is either increased or decreased in a period, the impact will be included in the tax provision in the statement of operations.

Significant management judgment is required in determining our provision for income taxes and the recoverability of our deferred tax asset. Such determination is based primarily on our historical taxable income, with some consideration given to our estimates of future taxable income by jurisdictions in which we operate and the period over which our deferred tax assets will be recoverable. Due to cumulative losses during the past three years, we established a \$2,241,000 valuation allowance against our deferred tax assets in the year ended June 30, 2009. The valuation allowance is recorded through income tax expense and included in the tax provision in the statement of operations.

**Net (Loss) Income.** We had a net loss of \$2,845,000 or \$0.29 per share, basic for the year ended June 30, 2009 compared to net income of \$317,000 or \$0.03 per share, basic, and \$0.03 per share, diluted, for the year ended June 30, 2008.

### Liquidity and Capital Resources

The following table presents selected financial statistics and information for the periods indicated:

|   | As of         |               |
|---|---------------|---------------|
|   | June 30, 2009 | June 30, 2008 |
| Cash and cash equivalents   | \$ 1,124,000  | \$ 517,000    |
| Working Capital <sup>1</sup>  | \$ 4,548,000  | \$ 4,586,000  |
| Credit Line outstanding balance   | \$ 0          | \$ 2,000,000  |
| Tangible book value/common share <sup>2</sup>   | \$ 0.75       | \$ 0.93       |
| Number of days of sales outstanding (DSO) in accounts receivable at end of quarter <sup>3</sup> | 41            | 48            |
|   | Year ended    |               |
|   | June 30, 2009 | June 30, 2008 |
| Net cash provided by operations   | \$ 1,718,000  | \$ 2,018,000  |

<sup>1</sup> Working Capital = Ending Current Assets balance - Ending Current liabilities balance

<sup>2</sup> Tangible book value/common share = {(Total shareholders' equity - Net intangible asset (patents) - Goodwill)}/(basic outstanding shares)

<sup>3</sup> DSO = Ending Net Accounts Receivable balance/(Previous Quarter Sales/91)

Our working capital at June 30, 2009 decreased \$38,000 (1%) to approximately \$4.5 million compared to approximately \$4.6 million at June 30, 2008. The reduced working capital is due to normal fluctuations.. Cash flow provided by operations was \$1,718,000 for the year ended June 30, 2009 compared to \$2,018,000 for the year ended June 30, 2008. Fiscal year 2009 cash was provided largely through a decrease in inventory (\$1,515,000), reduction in accounts receivable (\$609,000) and a recovery of state and federal tax payments from prior years (\$647,000) offset by a reduction in accounts payable (\$909,000) that occurred in the first part of the fiscal year.

Management believes that our working capital needs over the next twelve months can be adequately supported by current operations.

Issues Related to Credit Facilities

As of June 30, 2009, the Wells Fargo credit facility had two components:

- a revolving Credit Line Note ( line of credit ) of up to \$1,000,000 in borrowing availability, and
- a Five year Term Note (the TI Loan ) with an initial balance of \$2,000,000, of which \$1,766,667 was outstanding as of June 30, 2009.

The line of credit borrowing availability is a maximum of \$1,000,000. If borrowings under the Credit Line exceed \$500,000, the maximum amount of borrowing would be limited to 70% of the eligible accounts receivable plus 40% of the eligible inventory. Its terms require monthly interest payments at either (i) the prime rate of interest (3.25% at June 30, 2009) plus 1.50%, or (ii) three month LIBOR (.60% at June 30, 2009) plus 2.50%, at our discretion, based on outstanding borrowings. The credit facility expires on November 1, 2009. We are charged an unused credit line fee of 0.25% per annum payable quarterly on the average balance of the line of credit that is not used. There was no outstanding balance under the credit line as of June 30, 2009 and there continues to be no borrowing under such credit line as of September 11, 2009. Therefore, the total eligible additional borrowing capacity under the line of credit as of June 30, 2009 and as of September 11, 2009 was \$1,000,000.

The TI Loan had an initial balance of \$2,000,000. The borrowings from this term commitment were used for construction of tenant improvements for our Irvine, California facility. Its terms require monthly principal and interest payments over the 60 month life of the loan, based on outstanding borrowings. The interest rate is fixed at 5.72% over the life of the loan. There was a \$1,766,667 outstanding balance under the TI Loan as of June 30, 2009.

All assets of the Company except our Carson City land and building secure the outstanding borrowings under the Wells Fargo credit facility.

In March 2006, we entered into a ten year mortgage with Union Bank for \$1,650,000. The principal balance of the mortgage bears interest at a fixed annual rate of 6.73%. Payments on the mortgage are \$11,379 per month (based on a 25 year amortization), with the balance of \$1,291,666 in principal due on April 1, 2016. The mortgage is secured by our Carson City land and building. There was \$1,558,000 in principal outstanding under the mortgage as of June 30, 2009.

There are certain financial and non-financial covenants that the Company must meet to be in compliance with the terms of the Wells Fargo credit facility and mortgage with Union Bank. As of the year ended June 30, 2009, we were in compliance with the Wells Fargo covenants, however, we were in violation of the cash flow coverage covenant with Union Bank, with the violation resulting in an event of default under the facility. On August 25, 2009, we entered into a letter agreement with Union Bank pursuant to which Union Bank agreed to waive the covenant violation.

At June 30, 2009, we had cash and cash equivalents of \$1,124,000. We believe that our cash and cash equivalents on hand, together with cash flows from operations, if any, and amounts available under the credit facilities will be sufficient to meet our working capital and capital expenditure requirements for this and the next year.



In September 2002, our Board of Directors authorized the repurchase on the open market of up to 500,000 shares of our outstanding Common Stock at a share price no greater than \$1.25, subject to compliance with applicable laws and regulations. There is no requirement that we repurchase all or any portion of such shares. The maximum total value of the repurchase is not to exceed \$500,000. From the inception of the repurchase authorization through the fiscal year-end date of June 30, 2003, we repurchased 75,700 shares of Common Stock for \$43,741, at an average price of \$0.58 per share. No additional shares were repurchased in fiscal years 2004 through 2008. During the 2009 fiscal year, we repurchased 219,695 shares of common stock for \$133,472, at an average price of \$0.61 per share. Since the initiation of the buyback program in 2002 through June 30, 2009, we have repurchased 295,395 shares for \$177,213 at an average price of \$0.60 per share. Our Board suspended the buyback authorization in May 2009 and has not set a reinitiation date for the purchase of our shares pursuant to this program.

### **Impact of Possible NASDAQ Delisting**

The minimum bid price for our publicly traded common stock has remained below \$1.00 for a significant period of time during late 2008 and throughout 2009. Although Nasdaq had suspended its minimum bid requirement in October 2008, Nasdaq lifted that suspension on August 3, 2009 and we again face a delisting deadline date of January 7, 2010. If the minimum bid price for our stock does not rise above \$1.00 for the requisite number of days prior to such deadline or if we fail to meet any other listing requirement of the Nasdaq Capital Market, our common stock may be delisted from the Nasdaq Capital Market, which could negatively affect the value of our common stock. On January 9, 2009, our shareholders authorized us to engage in a reverse split of our Common Stock which may, as a result of increasing our per share price above \$1.00, provide us the means to avoid delisting. As the delisting deadline approaches and if the market price of our shares remains below \$1.00, our Board of Directors will continue to review the advisability of proceeding with a reverse split of our Common Stock or other actions.

### **Impact of Inflation and Changing Prices**

The industries in which we compete are labor intensive, often involving personnel with high-level technical or sales skills. Wages and other expenses increase during periods of inflation and when shortages in the marketplace occur. In addition, suppliers pass along rising costs to us in the form of higher prices. To some extent, we have been able to offset increases in operating costs by increasing charges, expanding services and implementing cost control measures. Nevertheless, our ability to increase prices is limited by market conditions, including international competition in many of our markets.

## Recent Accounting Pronouncements

The FASB has issued FASB Statement No. 165, *Subsequent Events*. The objective of SFAS 165 is to establish general standards of accounting for; and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. In particular, SFAS 165 sets forth:

- The period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements.
- The circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements.
- The disclosures that an entity should make about events or transactions that occurred after the balance sheet date.

On April 9, 2009, FASB issued FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*. The purpose of this FSP is to provide additional guidance in the application of FASB Statement No. 157; it supersedes FSP FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*.

Among other points, the FSP:

- affirms that the objective of fair value when the market for an asset is not active is the price that would be received to sell the asset in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions (that is, in the inactive market);
- clarifies and includes additional factors for determining whether there has been a significant decrease in market activity for an asset when the market for that asset is not active;
- eliminates the proposed presumption that all transactions are distressed (not orderly) unless proven otherwise. The FSP will instead require an entity to base its conclusion about whether a transaction was not orderly on the weight of the evidence;
- includes an example that provides additional explanation on estimating fair value when the market activity for an asset has declined significantly;
- requires an entity to disclose a change in valuation technique (and the related inputs) resulting from the application of the FSP and to quantify its effects, if practicable, by major category; and
- applies to all fair value measurements when appropriate.

The FASB has issued FASB Statement No. 168, The FASB Accounting Standards Codification<sup>TM</sup> and the Hierarchy of Generally Accepted Accounting Principles. Statement 168 establishes the FASB Accounting Standards Codification<sup>TM</sup>(Codification) as the single source of authoritative U.S. generally accepted accounting principles (U.S. GAAP) recognized by the FASB to be applied by nongovernmental entities. Rules and interpretive releases of the SEC under authority of federal securities laws are also sources of authoritative U.S. GAAP for SEC registrants. Statement 168 and the Codification are effective for financial statements issued for interim and annual periods ending after September 15, 2009.

When effective, the Codification will supersede all existing non-SEC accounting and reporting standards. All other non- grandfathered non-SEC accounting literature not included in the Codification will become non-authoritative. Following Statement 168, the FASB will not issue new standards in the form of Statements, FASB Staff Positions, or Emerging Issues Task Force Abstracts. Instead, the FASB will issue Accounting Standards Updates, which will serve only to: (a) update the Codification; (b) provide background information about the guidance; and (c) provide the bases for conclusions on the change(s) in the Codification.

#### **Item 7A. Quantitative and Qualitative Disclosures About Market Risks**

Not applicable.

**Item 8. Financial Statements and Supplementary Data**

The financial statements and supplemental data of the Company may be found in this Report on the pages indicated below.

|  |    |
|--|----|
| <u>Report of Independent Registered Public Company Accounting Firm</u> | 32 |
| <u>Consolidated Balance Sheet</u>                                      | 33 |
| <u>Consolidated Statements of Operations</u>                           | 34 |
| <u>Consolidated Statements of Shareholders' Equity</u>                 | 35 |
| <u>Consolidated Statements of Cash Flows</u>                           | 36 |
| <u>Notes to Consolidated Financial Statements</u>                      | 37 |

**Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.**

None.

**Item 9A(T). Controls and Procedures.**

The Chief Executive Officer and Chief Financial Officer (the principal executive officer and principal financial officer, respectively) conducted an evaluation of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended ( Exchange Act )). Based on that evaluation for the quarter ended June 30, 2009, the Chief Executive Officer and the Chief Financial Officer concluded that the disclosure controls and procedures are effective.

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act). Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework set forth in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, our management concluded that our internal control over financial reporting was effective as of June 30, 2009.

Our internal control over financial reporting is supported by written policies and procedures, that:

- (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets;
- (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of our

company are being made only in accordance with authorizations of our management and directors; and

(3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risks that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

This annual report does not include an attestation report of our registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by our registered public accounting firm pursuant to temporary rules of the SEC that permit us to provide only management's attestation in this annual report.

During the quarter ended June 30, 2009, there were no changes in the Company's internal controls over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act) that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

**Item 9B. Other Information.**

The minimum bid price for our publicly traded common stock has remained below \$1.00 for a significant period of time during late 2008 and throughout 2009. Although Nasdaq had suspended its minimum bid requirement in October 2008, Nasdaq lifted that suspension on August 3, 2009 and we again face a delisting deadline date of January 7, 2010. If the minimum bid price for our stock does not rise above \$1.00 for the requisite number of days prior to such deadline or if we fail to meet any other listing requirement of the Nasdaq Capital Market, our common stock may be delisted from the Nasdaq Capital Market, which could negatively affect the value of our common stock. On January 9, 2009, our shareholders authorized us to engage in a reverse split of our Common Stock which may, as a result of increasing our per share price above \$1.00, provide us the means to avoid delisting. As the delisting deadline approaches and if the market price of our shares remains below \$1.00, our Board of Directors will continue to review the advisability of proceeding with a reverse split of our Common Stock or other actions..

**PART III**

**Item 10. Directors, Executive Officers, Promoters, Control Persons and Corporate Governance; Compliance With Section 16(a) of the Exchange Act**

Information concerning the Company's Directors and Executive Officers is incorporated by reference from the information contained in the Company's definitive Proxy Statement for the Company's 2009 Annual Meeting of Shareholders to be filed with the SEC within 120 days after the end of the fiscal year ended June 30, 2009 (the "Proxy Statement").

**Item 11. Executive Compensation**

Information required by this Item is incorporated by reference from the Proxy Statement.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

Information required by this Item is incorporated by reference from the Proxy Statement.

**Item 13. Certain Relationships and Related Transactions, and Director Independence**

Information required by this Item is incorporated by reference from the Proxy Statement.

**Item 14. Principal Accountant Fees and Services**

Information required by this Item is incorporated by reference from the Proxy Statement.

**PART IV**

**Item 15. Exhibits**

(1) See Exhibit Index.



## **Report of Independent Registered Public Accounting Firm**

### **The Stockholders and Board of Directors**

#### **Pro-Dex, Inc.:**

We have audited the accompanying consolidated balance sheets of Pro-Dex, Inc. and Subsidiaries (the Company) as of June 30, 2009 and 2008 and the related consolidated statements of operations, shareholders' equity and cash flows for each of the years in the two-year period ended June 30, 2009. 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 consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated 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 financial position of Pro-Dex, Inc. and Subsidiaries as of June 30, 2009 and 2008, and the results of their operations and their cash flows for each of the two years in the two-year period ended June 30, 2009 in conformity with accounting principles generally accepted in the United States of America.

Irvine, California

September 17, 2009

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**PRO-DEX, INC. and SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

|  | <i>30-Jun-09</i> | <i>30-Jun-08</i> |
|--|------------------|------------------|
| <b>ASSETS</b>  |                  |                  |
| Current assets:  |                  |                  |
| Cash and cash equivalents  | \$ 1,124,000     | \$ 517,000       |
| Accounts receivable, net of allowance for doubtful accounts<br>of \$52,000 in 2009 and \$144,000 in 2008 | 2,515,000        | 2,842,000        |
| Other Current Receivables  | 16,000           | 205,000          |
| Inventories  | 3,365,000        | 5,101,000        |
| Prepaid expenses   | 117,000          | 214,000          |
| Prepaid income taxes   | 118,000          | 860,000          |
| Deferred income taxes  | -                | 1,176,000        |
| Total current assets   | 7,255,000        | 10,915,000       |
| Property, plant, equipment and leasehold improvements, net   | 5,981,000        | 6,470,000        |
| Other assets:  |                  |                  |
| Goodwill   | 2,997,000        | 2,997,000        |
| Intangibles - Patents, net   | 147,000          | 1,221,000        |
| Other  | 87,000           | 68,000           |
| Total other assets   | 3,231,000        | 4,286,000        |
| Total assets   | \$ 16,467,000    | \$ 21,671,000    |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                  |                  |
| Current liabilities:   |                  |                  |
| Line of credit   | \$ -             | \$ 2,000,000     |
| Accounts payable   | 827,000          | 1,736,000        |
| Accrued expenses   | 1,394,000        | 2,053,000        |
| Income taxes payable   | 53,000           | 114,000          |
| Current portion of term note   | -                | 396,000          |
| Current Portion of T.I. Loan   | 400,000          | -                |
| Current portion of real estate loan  | 33,000           | 30,000           |
| Total current liabilities  | 2,707,000        | 6,329,000        |
| Long-term liabilities:   |                  |                  |
| Notes Payable - T.I. Loan  | 1,367,000        | -                |
| Real estate loan   | 1,528,000        | 1,560,000        |
| Patent deferred payable  | -                | 44,000           |
| Deferred income taxes  | 171,000          | 290,000          |
| Deferred rent  | 212,000          | 150,000          |
| Total long-term liabilities  | 3,278,000        | 2,044,000        |
| Total liabilities  | 5,985,000        | 8,373,000        |
| Commitments and contingencies  |                  |                  |
| Shareholders' equity:  |                  |                  |
| Common shares; no par value; 50,000,000 shares authorized;   |                  |                  |
| 9,964,366 shares issued and 9,668,671 outstanding June 30, 2009  |                  |                  |
| 9,879,066 shares issued and 9,803,366 outstanding June 30, 2008  | 16,574,000       | 16,545,000       |
| Accumulated deficit  | (6,092,000)      | (3,247,000)      |

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|  |               |               |
|--|---------------|---------------|
| Total shareholders' equity   | 10,482,000    | 13,298,000    |
| Total liabilities and shareholders' equity<br><i>See notes to consolidated financial statements.</i> | \$ 16,467,000 | \$ 21,671,000 |

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**PRO-DEX, INC. and SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**Years ended June 30**

|  |                |               |
|--|----------------|---------------|
|  | <i>2009</i>    | <i>2008</i>   |
| Net sales  | \$ 21,122,000  | \$ 25,126,000 |
| Cost of sales  | 14,374,000     | 16,917,000    |
| Gross profit   | 6,748,000      | 8,209,000     |
| Operating expenses:  |                |               |
| Selling expense  | 1,295,000      | 1,482,000     |
| General and administrative expenses                              | 3,157,000      | 3,265,000     |
| Irvine facility move related general and administrative expenses | -              | 274,000       |
| Impairment of intangible asset                                   | 997,000        | -             |
| Research and development costs                                   | 2,791,000      | 2,732,000     |
| Total operating expenses   | 8,240,000      | 7,753,000     |
| (Loss) Income from operations                                    | (1,492,000)    | 456,000       |
| Other:   |                |               |
| Other (expense), net   | -              | (9,000)       |
| Royalty income   | 14,000         | 35,000        |
| Interest income  | 2,000          | 17,000        |
| Interest (expense)   | (228,000)      | (181,000)     |
| Total  | (212,000)      | (138,000)     |
| (Loss) Income before provision for income taxes                  | (1,704,000)    | 318,000       |
| Benefit (Provision) for Income Taxes                             | 1,100,000      | (1,000)       |
| Allowance for deferred tax asset                                 | (2,241,000)    | -             |
| Total Provision for Income taxes                                 | (1,141,000)    | (1,000)       |
| Net (Loss) Income  | \$ (2,845,000) | \$ 317,000    |
| Net (Loss) Income per share:                                     |                |               |
| Basic  | \$ (0.29)      | \$ 0.03       |
| Diluted  | \$ (0.29)      | \$ 0.03       |
| Weighted average shares outstanding - basic                      | 9,710,755      | 9,736,249     |
| Weighted average shares outstanding - diluted                    | 9,710,755      | 9,924,350     |

*See notes to consolidated financial statements.*



**PRO-DEX, INC. and SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY**  
**Years ended June 30**

|   | Common Shares       |               | Accumulated    | Total         |
|---|---------------------|---------------|----------------|---------------|
|   | Number<br>of Shares | Amount        | Deficit        |               |
| Balance 2006  | 9,539,792           | \$ 16,066,000 | \$ (3,995,000) | \$ 12,071,000 |
| Options exercised   | 93,574              | 32,000        |                | 32,000        |
| Issuance of restricted shares and Stock-<br>Based compenstion   | 85,000              | 242,000       |                | 242,000       |
| Net Income  |                     |               | 506,000        | 506,000       |
| Balance 2007  | 9,718,366           | \$ 16,340,000 | \$ (3,489,000) | \$ 12,851,000 |
| Cumulative retained earnings adjustment<br>for prior years due to accounting<br>standards change (FIN 48) | -                   | -             | (75,000)       | (75,000)      |
| Issuance of restricted shares and Stock-<br>Based compenstion   | 85,000              | 205,000       |                | 205,000       |
| Net Income  |                     |               | 317,000        | 317,000       |
| Balance 2008  | 9,803,366           | \$ 16,545,000 | \$ (3,247,000) | \$ 13,298,000 |
| Repurchase of Common Stock  | (219,695)           | (137,000)     |                | (137,000)     |
| Issuance of restricted shares and Stock-<br>Based compenstion   | 85,000              | 166,000       |                | 166,000       |
| Net (Loss)  |                     |               | (2,845,000)    | (2,845,000)   |
| Balance 2009  | 9,668,671           | \$ 16,574,000 | \$ (6,092,000) | \$ 10,482,000 |

*See notes to consolidated financial statements.*



**PRO-DEX, INC. and SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**Years ended June 30**

|  | 2009           | 2008        |
|--|----------------|-------------|
| Cash Flows from Operating Activities:  |                |             |
| Net Income   | \$ (2,845,000) | \$ 317,000  |
| Adjustments to reconcile net income to net cash used in operating activities:  |                |             |
| Depreciation and amortization  | 810,000        | 538,000     |
| Loss on Disposal   | 25,000         |             |
| Impairment of intangible asset   | 997,000        | -           |
| (Recovery of) Provision for doubtful accounts                                  | (92,000)       | (9,000)     |
| Stock based compensation   | 166,000        | 205,000     |
| Retained earnings adjustment for prior years due to accounting standard change | -              | (75,000)    |
| Deferred taxes   | 1,058,000      | 434,000     |
| Changes in:  |                |             |
| Decrease in accounts receivable  | 609,000        | 396,000     |
| Decrease (increase) in inventories   | 1,737,000      | (478,000)   |
| Decrease (increase) in prepaid expenses  | 97,000         | (9,000)     |
| (Increase) in other assets   | (20,000)       | (43,000)    |
| (Decrease) increase in accounts payable and accrued expenses                   | (1,505,000)    | 1,645,000   |
| Increase (decrease) in income taxes payable                                    | 681,000        | (903,000)   |
| Net Cash provided by Operating Activities                                      | 1,718,000      | 2,018,000   |
| Cash Flows From Investing Activities:  |                |             |
| Purchase of equipment and leasehold improvements                               | (269,000)      | (3,130,000) |
| Net Cash used in Investing Activities  | (269,000)      | (3,130,000) |
| Cash Flows from Financing Activities:  |                |             |
| Principal payments of patent deferred payable                                  | (45,000)       | (196,000)   |
| Net (payments) borrowing on Line of Credit                                     | (2,000,000)    | 1,700,000   |
| Principal (payments) on Term Note  | (396,000)      | (250,000)   |
| Net Principal borrowing on TI Loan   | 1,767,000      | -           |
| Principal payments on Real Estate Loan   | (31,000)       | (28,000)    |
| Stock Repurchases  | (137,000)      | -           |
| Net Cash (used in) provided by Financing Activities                            | (842,000)      | 1,226,000   |
| Net increase in Cash and Cash Equivalents                                      | 607,000        | 114,000     |
| Cash and Cash Equivalents, beginning of year                                   | 517,000        | 403,000     |
| Cash and Cash Equivalents, end of year   | \$ 1,124,000   | \$ 517,000  |
| <i>Supplemental Information</i>  |                |             |
| Cash paid for interest   | \$ 230,000     | \$ 181,000  |
| Cash paid for income taxes   | \$ -           | \$ 560,000  |

*See notes to consolidated financial statements.*



**PRO-DEX, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2009 and 2008**

**NOTE 1 DESCRIPTION OF BUSINESS**

Pro-Dex, Inc. specializes in bringing speed to market in the development and manufacture of technology-based solutions that incorporate miniature rotary drive systems, embedded motion control and fractional horsepower DC motors, serving the medical, dental, semi-conductor, scientific research and aerospace markets. Pro-Dex's products are found in hospitals, dental offices, medical engineering labs, commercial and military aircraft, scientific research facilities and high tech manufacturing operations around the world.

**NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Principles of Consolidation**

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, Pro-Dex Astromec, Inc. and Pro-Dex Management, Inc. Pro-Dex Management, Inc. is a non-operating subsidiary. All significant inter-company accounts and transactions have been eliminated.

**Basis of Presentation**

The accompanying consolidated financial statements have been prepared in accordance with accounting principals generally accepted in the United States of America.

## Revenue Recognition

Revenue on product sales is recognized upon shipment to the customer based on its terms of FOB shipping point, where the risk of loss and title transfer to the customer. We record sales in accordance with SEC Staff Accounting Bulletin No. 104, *Revenue Recognition*. Under these guidelines, revenue is recognized when all of the following exist: persuasive evidence that a sale arrangement exists, delivery of the product has occurred, the price is fixed or determinable, and payment is reasonably assured. We sell some of our products with a warranty that provides for repairs or replacement of any defective parts for a period after the sale. At the time of the sale, the Company accrues an estimate of the cost of providing the warranty based on prior experience, but does not accrue an allowance for sales returns. The Company recognizes revenue under research and development agreements as certain deliverables are met as specified in each development contract.

We seek customer-funded projects to customize generic rotary drive, motion control, and electric motor technology platforms to specific customer requirements. For customer-funded development projects, costs are capitalized and recognized as a cost of sales when specific deliverables within the development contracts are earned, matching the costs to the revenue. Revenue related to these fees can vary greatly due to the timing of contract milestones that prompt the revenue recognition. The results of customer-funded development work are intended to provide long-term exclusive manufacturing agreements and may provide the customer with the retention of the intellectual property developed. The identity of our customers is generally protected by a non-disclosure agreement.

Contract revenue for customer funded research and development is principally recognized based on the achievement of contractual milestones and the COS is recognized as the ratio of total actual incurred costs to date to total estimated costs for each contract (cost-to-cost method) in accordance with Statement of Position No. 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts. Generally, the Company reviews cost performance and estimates to complete on its ongoing contracts at least annually. The impact of revisions of profit estimates are recognized on a cumulative catch-up basis in the period in which the revisions are made.

Our estimates of contract costs are based on expectations of costs to deliver the milestone. These estimates can change based on unforeseen technology and integration issues, but known risk factors and contract challenges are generally allowed for in the initial scope and cost estimate of the program. Revisions in profit estimates are charged to income in the period in which the facts that give rise to the revision become known. In certain circumstances, specific contracts in which the Company cannot reliably make estimates of total revenues and expenses are accounted for under the completed contract method. Under the completed contract method, all revenue and expenses attributable to the specific contract are deferred until the end of the project.

### **Cash and Cash Equivalents**

The Company considers all highly liquid investments with an original maturity of ninety days or less to be cash equivalents.

### **Accounts Receivable**

Trade receivables are carried at original invoice amount less an estimate made for doubtful accounts based on a review of all outstanding amounts on a monthly basis. Management determines the allowance for doubtful accounts by identifying troubled accounts and using historical experience applied to an aging of accounts. Trade receivables are written off when deemed uncollectible. Recoveries of trade receivables previously written off are offset against the allowance when received. Changes in reserve for allowance for doubtful accounts are as follows for the years ended June 30, 2009 and 2008:

|                                      | Fiscal Year Ended June 30, |            |
|--------------------------------------|----------------------------|------------|
|                                      | 2009                       | 2008       |
| Balance at the beginning of the year | \$ 144,000                 | \$ 153,000 |
| Write off of doubtful accounts       | (39,000)                   | (3,000)    |
| Collection of doubtful accounts      | (53,000)                   | (6,000)    |
| Balance at the end of the year       | \$ 52,000                  | \$ 144,000 |

## Inventories

Inventories are stated at the lower of cost (the first-in, first-out method) or market and consist of the following at June 30, 2009 and 2008:

|                                  | Fiscal Year Ended June 30, |              |
|----------------------------------|----------------------------|--------------|
|                                  | 2009                       | 2008         |
| Raw Materials                    | \$ 1,290,000               | \$ 1,874,000 |
| Work in process                  | 866,000                    | 992,000      |
| Development costs under contract | -                          | 207,000      |
| Finished goods                   | 1,208,000                  | 2,028,000    |
| Total inventories                | \$ 3,364,000               | \$ 5,101,000 |

## Warranties

The warranty accrual is based on historical costs of warranty repairs and expected future identifiable warranty expenses. Warranty expenses are reflected in the financial statements in Cost of Sales ( COS ). The warranty accrual and expenses for the years ended June 30, 2009 and 2008 are presented below:

|   | Fiscal Year Ended June 30, |              |
|---|----------------------------|--------------|
|   | 2009                       | 2008         |
| Beginning Balance   | \$ 861,000                 | \$ 469,000   |
| Warranties issued during period                                     | \$ 664,000                 | \$ 1,337,000 |
| Adjustments to pre-existing warranties<br>due to assumption changes | \$ (406,000)               | \$ (39,000)  |
| Settlements (actual expenditures)                                   | \$ (601,000)               | \$ (906,000) |
| Ending Balance  | \$ 518,000                 | \$ 861,000   |

Accrued warranty expense was reduced during fiscal year ending June 30, 2009 compared to fiscal year ending June 30, 2008 due to fewer units shipped that were eligible for warranty coverage, reduced expected future per unit repair costs and reduced expected return percentages. The reduced repair costs reflect the average per unit actual cost to repair warranty eligible units and the reduced return percentage reflects expected return activity based on a rolling twelve month period. The repair costs and return profile assumptions are reviewed quarterly. The table below reflects the effects on the fiscal year ending June 30, 2009 and 2008 net income (loss) and net income (loss) per share for the assumption changes.

|   | Fiscal Year Ended June 30, |             |
|---|----------------------------|-------------|
|   | 2009                       | 2008        |
| Income (Loss) before provision for income taxes - before estimate change  | \$ (2,979,000)             | \$ 292,000  |
| Add: Impact of change in warranty reserve estimate assumptions            | \$ 406,000                 | \$ 39,000   |
| Less : Tax effect   | \$ (272,000)               | \$ (14,000) |
| Net Income (Loss) after provision of income taxes - after estimate change | \$ (2,845,000)             | \$ 317,000  |
| EPS - before provision for income taxes - before estimate change          | \$ (0.31)                  | \$ 0.03     |
| Add: Impact of change in warranty reserve estimate assumptions            | \$ 0.04                    | \$ 0.00     |
| Less : Tax effect   | \$ (0.03)                  | \$ (0.00)   |
| EPS - after provision of income taxes - after estimate change             | \$ (0.29)                  | \$ 0.03     |

### Property, Plant, Equipment & Leasehold Improvements, Net

Property, plant and equipment is recorded at cost and consist of the following as of June 30, 2009 and 2008:

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|                                       | Fiscal Year Ended June 30, |                |
|---------------------------------------|----------------------------|----------------|
|                                       | 2009                       | 2008           |
| Land                                  | \$ 757,000                 | \$ 757,000     |
| Building                              | \$ 1,470,000               | \$ 1,470,000   |
| Leasehold Improvements                | \$ 2,283,000               | \$ 2,259,000   |
| Equipment                             | \$ 6,620,000               | \$ 6,416,000   |
| Total                                 | \$ 11,130,000              | \$ 10,902,000  |
| Accumulated Depreciation              | \$ (5,149,000)             | \$ (4,432,000) |
| Total property, land & equipment, net | \$ 5,981,000               | \$ 6,470,000   |

Depreciation is provided using the straight-line method over the estimated useful lives of the assets as follows: Building - 39 years, equipment - 3 to 10 years; and leasehold improvements are depreciated over the shorter of the term of the lease or their estimated useful lives.



## Goodwill and Intangible Assets

The Company identifies two reporting units for purposes of its annual goodwill impairment testing arising from its acquisitions of Micro Motors and Astromec. In accordance with SFAS No. 142, goodwill is not amortized and is assessed annually for impairment (as of April 1) or whenever events or changes in circumstances indicate that the carrying value of such assets may not be recoverable. The Company's Carson City reporting unit corresponds to the operations resulting from the Astromec acquisition, while its Irvine reporting unit corresponds to the operations resulting from the Micro Motors acquisition.

We monitor current market conditions and review for potential triggering events quarterly to determine if there is a need for interim impairment testing. We did not determine that a triggering event for the Astromec and Micro Motors goodwill occurred in the past 12 months. Our standard annual impairment testing is done April 1 of each year.

In determining if a triggering event has occurred, we consider not only expectations for growth in the entire US economy, but also expectations for regional growth specific to our sales markets and specific to our industry and product lines.

|                                       | Fiscal Year Ended June 30, |              |
|---------------------------------------|----------------------------|--------------|
|                                       | 2009                       | 2008         |
| Goodwill Associated With Micro Motors | \$ 1,110,000               | \$ 1,110,000 |
| Goodwill Associated With Astromec     | 1,887,000                  | 1,887,000    |
| Total goodwill                        | \$ 2,997,000               | \$ 2,997,000 |

With regard to our patent, however, we did determine that a triggering event occurred, due to market conditions affecting its expected value. Intangible assets include the patents associated with the October, 2005 Intravantage asset purchase. Management tested the carrying amount of the Intravantage asset purchase for recoverability as of March 31, 2009. The result of management's analysis (based on several scenarios with varying probabilities of occurring) was that the asset's value was impaired and, accordingly a charge of \$997,000 was taken in the fiscal 2009 third quarter. See Note 10 for additional information. Total amortization expense in 2009 and 2008 was \$1,075,000 and \$99,000, respectively. Intangible assets consist of the following as of June 30, 2009 and 2008:

|                   | Fiscal Year Ended June 30, |              |
|-------------------|----------------------------|--------------|
|                   | 2009                       | 2008         |
| Intangible assets | \$ 4,178,000               | \$ 4,178,000 |

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|                          |              |              |
|--------------------------|--------------|--------------|
| Impairment               | \$ (997,000) | -            |
| Accumulated amortization | (3,034,000)  | (2,956,000)  |
| Total Intangible Assets  | \$ 147,000   | \$ 1,222,000 |

Future amortization expense for the fiscal years ending June 30 is:

|             |         |
|-------------|---------|
| 2010        | 13,000  |
| 2011        | 13,000  |
| 2012        | 13,000  |
| 2013        | 13,000  |
| 2014 - 2021 | 95,000  |
| Total       | 147,000 |

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## Stock Repurchase Plan

In September 2002, our Board of Directors authorized the repurchase on the open market of up to 500,000 shares of our outstanding Common Stock at a share price no greater than \$1.25, subject to compliance with applicable laws and regulations. There is no requirement that we repurchase all or any portion of such shares. The maximum total value of the repurchase is not to exceed \$500,000. From the inception of the repurchase authorization through the fiscal year-end date of June 30, 2003, we repurchased 75,700 shares of Common Stock for \$43,741, at an average price of \$0.58 per share. No additional shares were repurchased in fiscal years 2004 through 2008. During the 2009 fiscal year, we repurchased 219,695 shares of common stock for \$133,472, at an average price of \$0.61 per share. Since the initiation of the buyback program in 2002 through June 30, 2009, we have repurchased 295,395 shares for \$177,213 at an average price of \$0.60 per share. Our Board suspended the buyback authorization in May 2009 and has not set a reinitiation date for the purchase of our shares pursuant to this program.

| Period               | (a)                              | (b)                          | (c)  | (d)   |
|----------------------|----------------------------------|------------------------------|--|---|
|                      | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number (Approximate Dollar Value) of Shares that May Yet be Purchased Under the Plans or Programs |
| July 1-31, 2008      | 15,700                           | \$0.99                       | 91,400   | 408,600 (\$440,719)   |
| August 1-31, 2008    | 7,000                            | \$0.94                       | 98,400   | 401,600 (\$434,109)   |
| September 1-30, 2008 | 42,229                           | \$0.87                       | 140,629  | 359,371 (\$397,335)   |
| October 1-31, 2008   | 36,149                           | \$0.69                       | 176,778  | 323,222 (\$372,311)   |
| November 1-30, 2008  | 8,549                            | \$0.56                       | 185,327  | 314,673 (\$367,564)   |
| December 1-31, 2008  | 24,462                           | \$0.42                       | 209,789  | 290,211 (\$357,235)   |
| January 1-31, 2009   | 8,352                            | \$0.44                       | 218,141  | 281,859 (\$352,324)   |
| February 1-28, 2009  | 13,252                           | \$0.41                       | 231,393  | 268,607 (\$349,190)   |
| March 1-31, 2009     | 21,897                           | \$0.37                       | 253,290  | 246,710 (\$343,994)   |
| April 1-30, 2009     | 42,105                           | \$0.40                       | 295,395  | 204,605 (\$322,787)   |
| FY 2009 Total        | 219,695                          | \$0.61                       | 295,395  | 204,605 (\$322,787)   |

## Income Taxes

Deferred income taxes are provided on a liability method whereby deferred tax assets are recognized for deductible temporary differences, operating losses, and tax credit carry forwards. Deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax bases. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

### **Shipping and Handling**

The Company includes payments from its customers for shipping and handling in its net revenues line item in accordance with Emerging Issues Task Force ( EITF ) 00-10, *Accounting for Shipping and Handling Fees and Costs*. Shipping expenses, which consist primarily of payments made to freight companies, are reported in cost of goods sold.

### **Concentration of Credit Risk**

Financial instruments that potentially subject the Company to credit risk consist principally of cash and trade receivables. The Company places its cash with major financial institutions. At June 30, 2009 and 2008 and at various times throughout 2009 and 2008 the Company had deposits in excess of federally insured limits. Credit sales are made to resellers located throughout the United States and Europe, and account for a substantial portion of trade receivables. Such receivables are not collateralized, but we do monitor our customer s payment history.

## Stock Options and Warrants

We are subject to the revised requirements of the Statement of Financial Accounting Standards ( SFAS ) No. 123 (R) *Accounting for Stock-Based Compensation* as revised December 2004. This standard establishes the accounting standards for equity compensation, and applies to us in the recognition of the cost of stock options awarded based on the grant-date fair value of those awards.

Under SFAS No. 123(R), the fair value of stock-based awards to employees can be calculated through the use of option pricing models, even though such models were developed to estimate the fair value of freely tradable, fully transferable options with vesting restrictions which significantly differ from the Company's stock option awards. These models require subjective assumptions, including future stock price volatility and expected time to exercise, which greatly affect the calculated value. The volatility assumption is based on historical actual activity, with the future volatility expected to equal the past volatility. The expected time to exercise is based on the simplified model of the vesting time plus ½ the option life. The Company's calculations for the options granted were made using the Black-Scholes option-pricing model. The calculations are based on a single-option valuation approach and forfeitures are recognized.

The fair value and associated compensation cost of each grant is estimated at the grant date using the Black-Scholes option-pricing model with the following weighted-average assumptions: no dividend rate for all years; price volatility of 49% to 57% in 2009, of 58% to 63% in 2008; risk-free interest rates of approximately 3.3% to 4.9% in 2009 and 4.4% to 5.1% in 2008; and expected lives of five to eight years.

## Use of Estimates

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The Company's operations are affected by numerous factors including market acceptance, changes in technologies and new laws and government regulations and policies. The Company cannot predict what impact, if any, the occurrence of these or other events might have on the Company's operations. Significant estimates and assumptions made by management include, but are not limited to: revenue recognition, the allowance for doubtful accounts, the warranty

reserve, the reserve for slow moving or obsolete inventories, the carrying value of long-lived and intangible assets impairment of goodwill, and the recovery of deferred income tax assets.

Significant management judgment is required to determine our provision for income taxes and the recoverability of the deferred tax asset. It is based on estimates of future taxable income by jurisdiction in which the Company operates and the period over which the deferred tax assets will be recoverable. In the event that actual results differ from these estimates or we adjust these estimates in future periods, a valuation allowance may need to be established which could result in a tax provision equal to the carrying value of the deferred tax assets.

### **Earnings per Share**

Basic earnings per common share data has been computed on the basis of the weighted-average number of common shares outstanding during each period presented. Diluted per share amounts assume the conversion, exercise or issuance of all potential common stock instruments unless the effect is to increase the income or decrease the loss per common share from continuing operations.

## **Fair Value of Financial Instruments**

*Fair Value Measurements* Effective July 1, 2008, the Company adopted Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS 157) for financial assets and liabilities measured at fair value on a recurring basis. (See note 9) FAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements.

## **Research and Development**

Company-funded research and development supports the development of generic rotary drive, motion control and electric motor technology platforms. We seek customer-funded projects to customize generic rotary drive, motion control, and electric motor technology platforms to specific customer requirements. For customer-funded development projects, costs are capitalized and recognized as a cost of sales when specific deliverables within the development contracts are earned, matching the costs to the revenue. Revenue related to these fees can vary greatly due to the timing of contract milestones that prompt the revenue recognition. The results of customer-funded development work are intended to provide long-term exclusive manufacturing agreements and may provide the customer with the retention of the intellectual property developed. The identity of our customers is generally protected by a non-disclosure agreement. Company funded research and development costs not associated with contracts or purchase orders are expensed as incurred.

Contract revenue for customer funded research and development is principally recognized based on the achievement of contractual milestones and the COS is recognized as the ratio of total actual incurred costs to date to total estimated costs for each contract (cost-to-cost method) in accordance with Statement of Position No. 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*. Generally, the Company reviews cost performance and estimates to complete on its ongoing contracts at least annually. The impact of revisions of profit estimates are recognized on a cumulative catch-up basis in the period in which the revisions are made.

Our estimates of contract costs are based on expectations of costs to deliver the milestone. These estimates can change based on unforeseen technology and integration issues, but known risk factors and contract challenges are generally allowed for in the initial scope and cost estimate of the program. Revisions in profit estimates are charged to income in the period in which the facts that give rise to the revision become known. In certain circumstances, specific contracts in which we cannot reliably make estimates of total revenues and expenses are accounted for under the completed contract method. Under the completed contract method, all revenue and expenses attributable to the specific contract are deferred until the end of the project.

In the year ended June 30, 2009, \$475,000 was recognized as research and development related cost of sales, compared to \$119,000 recognized as such costs in the prior year ended. As of the end of fiscal year 2009, all engineering fee billings associated with customer projects have been completed and the capitalized expenses related to the projects were expensed.

### **Advertising**

Advertising costs are not capitalized, as all advertising expenditures are recognized in the period incurred as a selling expense. In the year ended June 30, 2009, we recognized \$102,000 for advertising, compared to \$140,000 in the year ended June 30, 2008.

### **NOTE 3 - BANK DEBT**

As of June 30, 2009, the Wells Fargo credit facility had two components:

- a revolving Credit Line Note ( line of credit ) of up to \$1,000,000 in borrowing availability, and
- a Five year Term Note (the TI Loan ) with an initial balance of \$2,000,000, of which \$1,766,667 was outstanding as of June 30, 2009.



The line of credit borrowing availability is a maximum of \$1,000,000. If borrowings under the Credit Line exceed \$500,000, the maximum amount of borrowing is limited to 70% of the eligible accounts receivable plus 40% of the eligible inventory. Its terms require monthly interest payments at either (i) the prime rate of interest (3.25% at June 30, 2009) plus 1.50%, or (ii) three month LIBOR (.60% at June 30, 2009) plus 2.50%, at our discretion, based on outstanding borrowings. The credit facility expires on November 1, 2009. We are charged an unused credit line fee of 0.25% per annum payable quarterly on the average balance of the line of credit that is not used. There was no outstanding balance under the credit line as of June 30, 2009 and there continues to be no borrowing under such credit line as of September 11, 2009. Therefore, the total eligible additional borrowing capacity under the line of credit as of June 30, 2009 was \$1,000,000 and as of September 11, 2009 is \$1,000,000.

The TI Loan had an initial balance of \$2,000,000. The borrowings from this term commitment were used for construction of tenant improvements for our Irvine, California facility. Its terms require monthly principal and interest payments over the 60 month life of the loan, based on outstanding borrowings. The interest rate is fixed at 5.72% over the life of the loan. There was a \$1,766,667 outstanding balance under the TI Loan as of June 30, 2009.

All assets of the Company except our Carson City land and building secure the outstanding borrowings under the Wells Fargo credit facility.

In March 2006, we entered into a ten year mortgage with Union Bank for \$1,650,000. The principal balance of the mortgage bears interest at a fixed annual rate of 6.73%. Payments on the mortgage are \$11,379 per month (based on a 25 year amortization), with the balance of \$1,291,666 in principal due on April 1, 2016. The mortgage is secured by our Carson City land and building. There was \$1,561,000 in principal outstanding under the mortgage as of June 30, 2009.

There are certain financial and non-financial covenants that the Company must meet to be in compliance with the terms of the Wells Fargo credit facility and mortgage with Union Bank. As of the year ended June 30, 2009, we were in compliance with the Wells Fargo covenants, however, we were in violation of the cash flow coverage covenant with Union Bank, with the violation resulting in an event of default under the facility. On August 25, 2009, we entered into a letter agreement with Union Bank pursuant to which Union Bank agreed to waive the covenant violation.

**NOTE 4 - COMMITMENTS AND CONTINGENCIES**

The Company leases its existing office and warehouse facilities in Irvine, California and Beaverton, Oregon. The Irvine lease expires in March 2018 and the Beaverton lease expires in April 2014. These leases require the Company to pay insurance, taxes, and other expenses related to the leased space. Total rent expense in 2009 and 2008 was \$572,000 and \$625,000, respectively. Future minimum lease payments for the fiscal year ending June 30 are:

|           |             |
|-----------|-------------|
| 2010      | \$469,137   |
| 2011      | \$488,325   |
| 2012      | \$507,585   |
| 2013      | \$526,917   |
| 2014      | \$531,847   |
| 2015-2018 | \$1,876,788 |
| Total     | \$4,400,599 |

Our manufacture and distribution of certain products involves a risk of legal action, and, from time to time, we are named as defendants in lawsuits. It is not reasonably possible to estimate the awards or damages, or the range of awards or damages, if any, we might incur in connection with such litigation. Other than the case pending with the Orange County Water District discussed below, management is not aware of any material actual, pending or threatened litigation at this time.

On June 23, 2009, the Orange County Water District ( OCWD ) filed a complaint in the Superior Court of the State of California in the County of Orange concerning remediation of alleged ground water contamination in the Orange County Groundwater South Basin; Orange County Water District v. Sabic Innovative Plastics U.S. LLC, et al., Case No. 00078246. The South Basin underlies parts of Santa Ana, California and adjacent cities. The complaint identifies 17 named defendants, including Pro-Dex, and also designates 400 unnamed Doe defendants. We moved out of this Santa Ana site in April, 2008 and have no remaining operations there.

The complaint alleges that the defendants contaminated the South Basin with volatile organic chemicals ( VOCs ) and perchlorate through various activities at properties each defendant now controls or has controlled in the past. Through its lawsuit, the OCWD seeks compensatory relief for all its own remedial activities, and injunctive relief to compel the defendants to undertake remedial activities in general. The complaint does not, however, specify any remedial activities that the OCWD has undertaken to date or any remedial activities that it seeks any particular defendants to undertake. Moreover, from our investigation of OCWD s remedial activities to date, we have determined that the OCWD is in the early stages of its remedial investigation for the South Basin groundwater contamination.

As noted above, 16 other entities are named defendants in this case along with Pro-Dex. While some are small businesses, others are larger corporations or their subsidiaries. Further, as this case progresses, the OCWD is likely to add at least a few more named defendants to the case from the 400 Doe defendants it has designated in the current complaint. In the indeterminable event that we would be held liable in the case, OCWD s total recovery probably would be allocated among several defendants, each of which would pay only a proportionate share of that total recovery.

One of our past insurers has committed to pay most of our defense costs for the lawsuit, while reserving its rights as to whether it will cover any damages awarded against us, or any settlement payment to which Pro-Dex agrees to resolve the lawsuit, under past policies issued to us for a three-year period, March 31, 1983 to March 31, 1986. The policies for these three years have occurrence payment limits of \$500,000 for each annual term.

Overall, the OCWD complaint remains vague, the OCWD is in an early stage of its remedial activities in the South Basin, the lawsuit is in the early stages of discovery, one of our insurers has committed to pay most defense costs and has reserved rights under one three-year set of policies and is continuing to consider extending coverage to us under other past policies, and any recovery the OCWD may gain through the lawsuit is likely to be allocated among several defendants. Therefore, our liabilities, as well as our costs of defending, monitoring and concluding our involvement in this case are uncertain, and those costs cannot now be estimated.

#### **NOTE 5 - INCOME TAXES**

The provisions for income taxes for the years ended June 30, 2009 and 2008 are as follows:

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|           |                            | Fiscal Year ended June 30, |              |
|-----------|----------------------------|----------------------------|--------------|
|           |                            | 2009                       | 2008         |
| Current:  |                            |                            |              |
|           | Federal                    | \$ 97,000                  | \$ (403,000) |
|           | State                      | (14,000)                   | (29,000)     |
| Deferred: |                            |                            |              |
|           | Federal                    | 587,000                    | 425,000      |
|           | State                      | 471,000                    | 8,000        |
|           | Provision for Income taxes | \$ 1,141,000               | \$ 1,000     |

A reconciliation of the expected tax to the amount computed by applying the federal statutory income tax rates to income before income taxes is as follows:

|   |  | Fiscal Year ended June 30, |            |
|---|--|----------------------------|------------|
|   |  | 2009                       | 2008       |
| Federal income tax provision at the statutory rate    |  | \$ (579,000)               | \$ 108,000 |
| Change in valuation allowance for deferred tax assets |  | \$ 2,241,000               | \$ -       |
| State income taxes, net of federal tax benefit        |  | (275,000)                  | 39,000     |
| Tax Incentives  |  | (255,000)                  | (122,000)  |
| Non-deductible items                                  |  | 28,000                     | 51,000     |
| FIN 48 Liability                                      |  | (19,000)                   | (84,000)   |
| Other   |  | -                          | 9,000      |
| Provision for Income taxes                            |  | \$ 1,141,000               | \$ 1,000   |

Deferred income tax assets and liabilities in the accompanying consolidated balance sheet at June 30, 2009 and 2008 are as follows:

|                                     |  | Fiscal Year ended June 30, |              |
|-------------------------------------|--|----------------------------|--------------|
|                                     |  | 2009                       | 2008         |
| Current Deferred income tax assets  |  |                            |              |
| Deferred tax assets                 |  |                            |              |
| Accrued expenses                    |  | \$ 403,000                 | \$ 535,000   |
| Inventories                         |  | 830,000                    | 660,000      |
| Net Operating Losses                |  | 680,000                    | 73,000       |
| State Taxes                         |  | 87,000                     | (92,000)     |
| Income tax credit carry forwards    |  | -                          | -            |
| Total deferred tax assets (current) |  | 2,000,000                  | 1,176,000    |
| Valuation Allowance                 |  | (2,000,000)                | -            |
| Deferred tax assets, net            |  | \$ -                       | \$ 1,176,000 |

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| Long Term Deferred income tax assets/(liabilities) | Fiscal Year ended June 30, |              |
|--|----------------------------|--------------|
|  | 2009                       | 2008         |
| Intangible assets                                  | \$ 493,000                 | \$ 268,000   |
| Non cash stock based compensation                  | 16,000                     | 113,000      |
| Income tax credit carry forwards                   | 569,000                    | 351,000      |
| State Taxes  | (76,000)                   | (57,000)     |
| Depreciation                                       | (932,000)                  | (965,000)    |
| Total deferred tax assets (non-current)            | 70,000                     | (290,000)    |
| Valuation Allowance                                | (241,000)                  | -            |
| Deferred tax assets, net                           | \$ (171,000)               | \$ (290,000) |
| Net Deferred tax assets/(liabilities)              | \$ (171,000)               | \$ 886,000   |

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We have federal net operating loss carry forwards for June 30, 2009 and 2008 of \$1,515,000 and \$0, respectively. We have state net operating loss carry forwards for June 30, 2009 and 2008 of \$2,305,000 and \$1,002,000, respectively. The Company has federal tax credits of \$276,000 and \$103,000 for June 30, 2009 and 2008, respectively, and state tax credits of \$285,000 and \$248,000 for June 30, 2009 and 2008, respectively.

Significant management judgment is required in determining our provision for income taxes and the recoverability of our deferred tax asset. Such determination is based primarily on our historical taxable income, with some consideration given to our estimates of future taxable income by jurisdictions in which we operate and the period over which our deferred tax assets will be recoverable. Due to cumulative taxable losses during the past three years, we recorded \$2,241,000 valuation allowance against our deferred tax assets in the year ended June 30, 2009. This reduction in deferred tax assets is adjusted through income tax expense.

A reconciliation of the beginning and ending amount of valuation allowance is as follows:

|   |                |
|---|----------------|
| Balance at July 1, 2008                   | \$ -           |
| Increase in tax asset valuation allowance | (2,241,000)    |
| Balance at June 30, 2009                  | \$ (2,241,000) |

As of June 30, 2009, pursuant to FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, we have accrued \$54,000 of uncertain tax positions related state income tax matters that would reduce the Company's income tax expense if recognized and would result in a corresponding decrease in the Company's effective tax rate.

During the year ended June 30, 2009, the Internal Revenue Service settled its audit of our federal income tax returns for the fiscal years ended June 30, 2004 through June 30, 2006. This settlement resulted in the reversal of \$41,000 of unrecognized tax benefits associated with Section 263A costs we reported, which reduced our tax expense by \$6,000.

During the year, we filed amended state returns for the fiscal years ended June 30, 2004 through June 30, 2006 to report the related changes to the Section 263A costs. The filing of the amended state tax returns resulted in the reversal of \$9,000 of unrecognized tax benefits associated with the Section 263A costs we reported, which reduced our tax expense by \$1,000. Our remaining liability for uncertain tax positions, related to the fiscal years ended June 30, 2005 through June 30, 2009, is \$54,000 as of June 30, 2009. We have not identified any new unrecognized tax benefits.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

|  |          |         |
|--|----------|---------|
| Balance at July 1, 2008                                      | \$       | 114,000 |
| Additions based on tax positions related to the current year | 0        |         |
| Additions for tax positions of prior years                   | 6,000    |         |
| Reductions for tax positions of prior years                  | (16,000) |         |
| Settlements  | (50,000) |         |
| Balance at June 30, 2009                                     | \$       | 54,000  |

We recognize accrued interest and penalties related to unrecognized tax benefits in income tax expense. As of June 30, 2009, the Company had approximately \$12,000 in accrued interest and penalties which is included as a component of the \$54,000 unrecognized tax benefit noted above. The liability for the payment of interest and penalties has increased by approximately \$6,000 for the twelve months ended June 30, 2009.



Pro-Dex and its subsidiaries are subject to U.S. federal income tax, as well as income tax of multiple state tax jurisdictions. We are currently open to audit under the statute of limitations by the Internal Revenue Service for the years ended June 30, 2007 and June 30, 2008. Our state income tax returns are open to audit under the statute of limitations for the years ended June 30, 2005 through June 30, 2008. We do not anticipate a significant change to the total amount of unrecognized tax benefits within the next 12 months.

## NOTE 6 - SHARE-BASED COMPENSATION

### Stock Options

The Board of Directors and the shareholders of the Company have approved and adopted two equity compensation plans, pursuant to which i) options to purchase common stock or ii) restricted shares, may be granted up to an aggregate amount of 2,500,000 shares of common stock to officers, directors, and employees of the Company. Upon its adoption, the employee stock option plan had 2,000,000 shares of common stock available for issuance and the directors plan had 500,000 shares of common stock available for issuance. The option plans are substantially similar, call for vesting as approved by the Board of Directors of six months for directors and up to five years for employees, and allow for the options to be outstanding for a period of up to ten years but are forfeited 30 days after the holder ceases to be an employee and are forfeited 90 days after the holder ceases to be director. There are options to purchase 346,045 shares remaining under the employee option plan, and options to purchase 130,000 shares remaining under the directors option plan for a total of 476,045 shares remaining under both option plans at June 30, 2009, that are available to grant in future years. New shares are issued as such options are exercised or restricted shares are granted. Share-based compensation expense reduced the Company's results of operations as shown:

|  | Fiscal Year ended June 30, |          |
|--|----------------------------|----------|
|  | 2009                       | 2008     |
| Share-based compensation expense recognized: |                            |          |
| General and administrative, options          | 49,000                     | 87,000   |
| General and administrative, restricted stock | 117,000                    | 117,000  |
| Subtotal expense                             | 166,000                    | 204,000  |
| Related deferred tax benefit                 | -                          | (47,000) |
| Decrease in net income                       | 166,000                    | 157,000  |
| <br>   |                            |          |
| Decrease in basic earnings per share         | \$ 0.02                    | \$ 0.02  |
| Decrease in diluted earnings per share       | \$ 0.02                    | \$ 0.02  |

As of June 30, 2009, there was \$48,000 of total unrecognized compensation cost related to 102,250 non vested outstanding stock options with a per share weighted average value of \$1.08. The unrecognized expense is anticipated to be recognized on a straight-line basis over a weighted average period of 0.9 years.

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The following is a summary of stock option activity:

|   | 2009      | Weighted-<br>Average<br>Exercise Price | 2008      | Weighted-<br>Average<br>Exercise Price |
|---|-----------|--|-----------|--|
| Fixed Options   | Shares    |  | Shares    |  |
| Outstanding at beginning of year                                  | 1,109,500 | \$ 1.58                                | 1,038,500 | \$ 1.60                                |
| Granted   | 106,000   | 0.62                                   | 101,000   | 1.50                                   |
| Exercised   | -         | -                                      | -         | -                                      |
| Forfeited   | (282,500) | 1.75                                   | (30,000)  | 1.86                                   |
| Outstanding at end of year  | 933,000   | \$ 1.42                                | 1,109,500 | \$ 1.58                                |
| Exercisable at end of year  | 830,750   | \$ 1.46                                | 986,500   | \$ 1.58                                |
| Weighted-average fair value per<br>Option granted during the year |           | \$ 0.28                                |           | \$ 0.79                                |

The following table summarizes information regarding options outstanding and options exercisable at June 30, 2009:

| Range of<br>Exercise Price | Number<br>Outstanding | Options Outstanding                                   |   |                                 | Options Exercisable                       |                                 |          |
|----------------------------|-----------------------|---|---|---------------------------------|---|---------------------------------|----------|
|                            |                       | Weighted-<br>Average<br>Remaining<br>Contractual Life | Weighted-<br>Average<br>Exercise<br>Price | Aggregate<br>Intrinsic<br>Value | Weighted-<br>Average<br>Exercise<br>Price | Aggregate<br>Intrinsic<br>Value |          |
| \$0.42 to \$0.81           | 296,000               | 4.1. years  | \$ 0.66                                   | \$ 1,200                        | 250,000                                   | \$ 0.70                         | \$ 1,200 |
| \$1.00 to \$1.56           | 357,000               | 4.9 years   | 1.33                                      | \$ -                            | 307,000                                   | 1.31                            | \$ -     |
| \$1.74 to \$2.18           | 190,000               | 2.2 years   | 2.07                                      | \$ -                            | 190,000                                   | 2.07                            | \$ -     |
| \$2.55 to \$3.30           | 90,000                | 6.0 years   | 2.89                                      | \$ -                            | 83,750                                    | 2.91                            | \$ -     |
| Total                      | 933,000               | 4.2 years   | \$ 1.42                                   | \$ 1,200                        | 830,750                                   | \$ 1.46                         | \$ 1,200 |

### Restricted Stock

In connection with the employment agreement with our Chief Executive Officer, a restricted stock grant of 340,000 shares of common stock was made in February 2007. These shares vest in four equal installments of 25% or 85,000 shares per year over 4 years. The common stock price at the date of the grant was \$1.38. New shares are issued with the vesting of each installment of restricted stock. The fair value of the grant is calculated as the number of shares multiplied by the grant price. The compensation expense is recognized over the vesting period of the grant. Approximately \$117,000 in compensation expense for the restricted stock was recognized in fiscal year 2009.

The following is a summary of restricted share activity:

|                                  | 2009     | Weighted-      | 2008     | Weighted-      |
|----------------------------------|----------|----------------|----------|----------------|
|                                  | Shares   | Average        | Shares   | Average        |
| Restricted shares                |          | Exercise Price |          | Exercise Price |
| Outstanding at beginning of year | 170,000  | \$ 1.38        | 255,000  | \$ 1.38        |
| Granted                          | -        | -              | -        | -              |
| Vested                           | (85,000) | 1.38           | (85,000) | 1.38           |
| Forfeited                        | -        | -              | -        | -              |
| Outstanding at end of year       | 85,000   | \$ 1.38        | 170,000  | \$ 1.38        |
| Exercisable at end of year       | -        | \$ -           | -        | \$ -           |

As of June 30, 2009, there was \$78,200 of total unrecognized compensation cost related to 85,000 non vested outstanding restricted shares with a per share weighted average value of \$1.38. The unrecognized expense is anticipated to be recognized on a straight-line basis over a weighted average period of 0.7 years.

### Stock Warrants

At June 30, 2009, warrants to acquire 100,000 shares of common stock expired. There are no remaining warrants outstanding.

|   | 2009      | Weighted-      | 2008    | Weighted-      |
|---|-----------|----------------|---------|----------------|
|   | Shares    | Average        | Shares  | Average        |
|   |           | Exercise Price |         | Exercise Price |
| Warrants Outstanding at beginning of year | 100,000   | \$ 1.25        | 100,000 | \$ 1.25        |
| Granted                                   | -         | -              | -       | -              |
| Exercised                                 |           |                |         |                |
| Forfeited                                 | (100,000) | 1.25           | -       | -              |
| Outstanding at end of year                | -         | \$ -           | 100,000 | \$ 1.25        |
| Exercisable at end of year                | -         | \$ -           | 100,000 | \$ 1.25        |

### NOTE 7 - NET INCOME PER SHARE

The following table reconciles the weighted average shares outstanding for basic and diluted net income per share for the years ended June 30 as indicated.

|  | 2009           | 2008       |
|--|----------------|------------|
| Net income (loss)                                    | \$ (2,845,000) | \$ 317,000 |
| Basic net income per common share:                   |                |            |
| Weighted average number of common shares outstanding | 9,710,755      | 9,736,429  |
| Basic net income per common share                    | \$ (0.29)      | \$ 0.03    |

Diluted net income per share:

|   |           |           |
|---|-----------|-----------|
| Weighted average of common shares outstanding                 | 9,710,755 | 9,736,429 |
| Effect of potentially dilutive securities (options)           | -         | 169,761   |
| Effect of potentially dilutive securities (restricted shares) | -         | 8,160     |
| Effect of potentially dilutive securities (warrants)          | -         | 10,000    |
| Diluted weighted average number of common and shares          | 9,710,755 | 9,924,350 |
| Diluted net income per common share                           | \$ (0.29) | \$ 0.03   |

Potentially dilutive securities not included in the diluted loss per share calculation due to net losses from continuing operations and for options that have a strike price higher than the market price for our common stock (no intrinsic value) are as follows:

|  | 2009    | 2008      |
|--|---------|-----------|
| Options to purchase common shares                  | 835,793 | 945,503   |
| Restricted Shares                                  | 50,993  | 101,986   |
| Warrants to purchase common shares                 | -       | 59,993    |
| Total potentially dilutive securities not included | 886,786 | 1,107,482 |

**NOTE 8 - MAJOR CUSTOMERS**

We had two major customers (defined as a customer that represented greater than 10% of the Company's total revenues) in the year ended June 30, 2009 and 2008.

|            | Year ended June 30, |             |              |             |
|------------|---------------------|-------------|--------------|-------------|
|            | 2009                |             | 2008         |             |
|            | Revenues            | Accts. Rec. | Revenues     | Accts. Rec. |
| Customer 1 | \$ 4,232,000        | \$ 513,000  | \$ 4,429,000 | \$ 408,000  |
| Customer 2 | \$ 6,530,000        | \$ 730,000  | \$ 8,075,000 | \$ 621,000  |

**NOTE 9. - FAIR VALUE MEASUREMENTS**

*Fair Value Measurements* Effective July 1, 2008, the Company adopted Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS 157) for financial assets and liabilities measured at fair value on a recurring basis. SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. In addition to expanding the disclosures surrounding fair value measurements, SFAS 157 indicates that fair value represents the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is determined based upon assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, SFAS 157 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value as follows:

- Level 1 - Valuations based on unadjusted quoted prices in active markets for identical assets or liabilities that the Company has the ability to access.
- Level 2 - Valuations based on quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly.
- Level 3 - Valuations based on inputs that are unobservable and significant to the overall fair value measurement.

In many cases, a valuation technique used to measure fair value includes inputs from multiple levels of the fair value hierarchy described above. The lowest level of significant input determines the placement of the entire fair value measurement in the hierarchy.

The following valuation methodology was used for the company's assets to measure fair value at June 30, 2009:

*Cash and cash equivalents:* The carrying value of cash and cash equivalents is considered to be representative of their fair values based on the short term nature of these instruments. As such these investments are classified within level 1 of the valuation hierarchy.



The following fair value hierarchy table presents information about the company's assets measured at fair value on a recurring basis as of June 30, 2009:

| Description               | Level 1      | Level 2 | Level 3 | Total        |
|---------------------------|--------------|---------|---------|--------------|
| Cash and cash equivalents | \$ 1,124,000 |         |         | \$ 1,124,000 |
| Total                     | \$ 1,124,000 | \$ -    | \$ -    | \$ 1,124,000 |

#### **NOTE 10. - INTANGIBLE ASSET IMPAIRMENT**

In accordance with Statement of Financial Accounting Standards ( SFAS ), SFAS No. 144, Accounting for the Impairment or Disposal for Long-Lived Assets ( SFAS 144 ) long-lived assets and intangible assets with definite lives are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Impairment indicators include, among other conditions, cash flow deficits, historic or anticipated declines in revenue or operating profit and adverse legal or regulatory developments. If it is determined that such indicators are present and the review indicates that the assets will not be fully recoverable, based on undiscounted estimated cash flow over the remaining amortization periods, their carrying values are reduced to estimated fair market value. Estimated fair market value is determined primarily using the anticipated cash flow discounted at a rate commensurate with the risk involved. For the purposes of identifying and measuring impairment, long-lived assets are grouped with other assets and liabilities at the lowest level for which identifiable cash flow are largely independent of the cash flow of other assets and liabilities. Our standard annual impairment testing is done April 1 of each year.

We monitor current market conditions and review for potential triggering events quarterly to determine if there is a need for interim impairment testing. We did not determine that a triggering event for the Astromec and Micro Motors goodwill occurred in the past 12 months. We did however; determine that a triggering event occurred with the patent intangible asset.



In determining if a triggering event has occurred, we consider not only expectations for growth in the entire US economy, but also expectations for regional growth specific to our sales markets and specific to our industry and product lines. While our operating units are influenced by changes in the general economic outlook of the United States, they are most heavily influenced by changes specific to the medical device industry. Furthermore, the magnitude of economic changes within the industry is viewed alongside the outlooks and forecasts specific to the reporting units to obtain a better sense of the likelihood that goodwill may be impaired. Declines within the industry's outlook are reflected in the unit's revenue projections.

We identify two reporting units for purposes of our annual goodwill impairment testing arising from its acquisitions of Micro Motors and Astromec. In accordance with SFAS No. 142, goodwill is not amortized and is assessed annually for impairment (as of April 1) or whenever events or changes in circumstances indicate that the carrying value of such assets may not be recoverable. Our Carson City reporting unit corresponds to the operations resulting from the Astromec acquisition, while our Irvine reporting unit corresponds to the operations resulting from the Micro Motors acquisition. Our intangible asset is related to the interosseous patents associated with the Intraflow acquisition.

Goodwill and Intangible assets are tested for impairment using a discounted cash flow analysis. The discounted cash flow analysis relies upon estimates of the entity's future revenue and expenses to ultimately project the future cash flows resulting from the business activity of each entity. The projected future cash flows are discounted to present value at an appropriate discount rate. An appropriate discount rate is reached by calculating the weighted average cost of capital (WACC), which is determined by the assumptions underlying the Capital Asset Pricing Model (CAPM) and is considered to reflect the view of Market Participants, as required under SFAS 157. The inputs used in calculating the WACC are described below.

- a. The assumed capital structure is based upon the Company's actual capital structure and debt to equity ratio at the time of analysis.
- b. The cost of debt is based on the Company's actual contracted rates.
- c. The cost of equity is equal to the risk free rate represented by the 10 year Treasury note, plus the Company's historical correlation to market movement (beta) times the historical equity risk premium, plus an additional small stock premium.
- d. In valuing the Company's patents, an additional risk premium is added to reflect the increased risk inherent in intangible assets.
- e. Also in valuing the patents, an expected value calculation was performed that weighted the values of different scenarios based on their expected probability of occurrence.

We performed separate calculations to determine the sensitivity of our intangible asset impairment conclusions to increases in the assumed discount rates. In the case of Astromec, the goodwill impairment test is not failed until the discount rate is increased to 33 percent. In the case of Micro Motors, the goodwill impairment test is not failed until the discount rate is increased to 240 percent.

Additionally, the material assumptions relied upon in the discounted cash flow analysis used to value the Company's Intraflow patents are shown below.

- a. The patent is valued from the perspective of Market Participants, which are believed to possess sales and marketing expertise in the dental and medical device field. Management's financial analysis of the intangible asset was performed from the perspective of a potential acquirer and estimates what a Market Participant would be willing to pay for the asset. This methodology is consistent with FAS 157 requirements for Fair Value estimates to be estimates of the price that would be received to sell an asset, or an Exit Price. In these scenarios, the patents' value is based on the assumed greater distribution capabilities and lower incremental costs that would be held by Market Participants.
- b. The patent was also valued as a ongoing product line without any additional distribution partner or Market Participant value.
- c. A premium for the increased riskiness of intangible assets was included in the asset's discount rate.

- d. We performed separate calculations to determine the sensitivity of the asset's impairment conclusion to variances in sales growth, gross margin, and discount rate. Sales growth forecasts ranged from growth of 6 times to 12 times 2008 levels.
- e. There were transaction and/or start-up costs associated with the Market Participants valuation.

The material assumptions relied upon in the discounted cash flow analysis used to value the goodwill held in the Carson City reporting unit are shown below.

- a. Goodwill resulting from the Company's acquisition of Astromec is tested for impairment under its Carson City motor manufacturing operations.
- b. Motor sales of existing products are assumed to decline as products age, but are more than replaced by revenue growth from new products and increased intercompany sales for medical hand piece products.
- c. The existing fixed cost structure of the motor manufacturing operations will be better absorbed by the higher forecasted volume of production, resulting in increased profit margins.
- d. In addition to the value of the goodwill held in the Carson City reporting unit as if it stands alone, an additional analysis is performed to estimate a value to Pro-Dex of having an in-house motor manufacturer for the medical device product line. This captive capability enables development speed and focus, which produces revenue in other operating units.
- e. The value of the Carson City manufacturing operation is added to the value of the additional capability provided to Pro-Dex for the total value of the goodwill.

The material assumptions relied upon in the discounted cash flow analysis used to value the goodwill held in the Micro Motors reporting unit are shown below.

- a. Goodwill resulting from the Company's acquisition of Micro Motors is tested for impairment under its Irvine reporting unit, which houses the operations resulting from the base technology acquired from Micro Motors.
- b. Sales to existing customers are assumed to decline, but are more than replaced by revenue growth from new customers.

The existing fixed cost structure of the Irvine operations will be better absorbed by the higher forecasted volume of medical products, resulting in increased profit margins.

Given the company's lack of a direct dental distribution channel, it has stopped actively promoting the product based on the intangible asset resulting from the purchase of certain assets from IntraVantage, Inc. in October 2005. Any substantial future value therefore stems from the possibility that a company with a direct dental distribution channel (a Market Participant) might be interested in access to the technology through product purchases, licenses, acquisition, joint venture, or other means. Given the current economic environment, the general lack of investment in new products, the limited number of Market Participants to whom this technology relates, the time and expense necessary to consummate a transaction, and other factors considered by management, there is also a significant possibility that no distribution partner will be found, resulting in effectively no value of the asset. Given this change in circumstance, in accordance with FAS 144 Accounting for the Impairment or Disposal of Long-Lived Assets, management tested the carrying amount of the intangible asset for recoverability as of March 31, 2009. The result of management's analysis based on several scenarios (with varying probability of occurring) was that the asset's expected value at that date was \$150,000 and, accordingly a charge of \$997,280 was taken in the fiscal 2009 third quarter. The asset continued to amortize its remaining value over the remaining patent's life. As to June 30, 2009, the patent's intangible carrying value was \$147,000. Management remains committed to optimizing the value of this technology for our shareholders, and will continue to pursue any opportunity to accomplish that end.

For the Astromec reporting unit's impairment testing there was an assumption of decreased external sales growth compared to 2008, which was more than offset by an increased sales growth rate of motors for internal (Pro-Dex) use. In addition to the value of the reporting unit as an internal supplier and stand alone business, the unit has additional strategic value by enabling Pro-Dex to gain additional customers under other reporting units that is considered in the valuation. It should be noted that the unit passes its goodwill impairment test without the inclusion of this additional enablement value.

For the Micro Motors reporting unit's impairment testing, there was an assumption of a slower than historical sales growth rate than in the previous valuation. The total 5 year growth rate in the 2008 valuation was equal to the historical 5 year growth rate of the Company, but the growth rate was reduced by 50% for the 2009 valuation. The reason for the reduced sales growth is the current and forecast near and medium term market conditions. The effect of this sales growth decrease was to decrease the unit's calculated value, but not to an extent that it fails the goodwill impairment test. The computed reporting unit value exceeds the carrying value of the unit by more than 100 percent.

#### **NOTE 11. SUBSEQUENT EVENTS**

We have evaluated events or transactions that occurred after the balance sheet date of June 30, 2009 through September 16, 2009. There were no subsequent events to recognize.

#### **Item 1. Index to Exhibits**

##### **Exhibit No. Document**

- 3.1 Articles of Incorporation (incorporated herein by reference to Exhibit 3.1 to the Company's Form 8-K filed April 23, 2008).
- 3.2 Bylaws (incorporated herein by reference to Exhibit 3.2 to the Company's Form 8-K filed April 23, 2008).
- 10.1\* 1994 Employees Stock Option Plan, as amended (incorporated herein by reference to Exhibit 10.22 to the Company's Registration Statement on Form S-4 filed April 13, 1994).
- 10.2\* 1994 Directors Stock Option Plan as amended (incorporated herein by reference to Exhibit 10.22 to the Company's Registration Statement on Form S-4 filed April 13, 1994)

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- 10.3\* First Amended and Restated 2004 Stock Option Plan (incorporated herein by reference to Exhibit 4.0 to the Company's Form S-8 filed March 9, 2008).
- 10.4\* 2004 Directors Stock Option Plan (incorporated herein by reference to Exhibit 4.2 to the Company's Form S-8 filed January 23, 2004).
- 10.5 Audit Committee Charter (incorporated herein by reference to Exhibit 10.26 to the Company's Form 10-K filed October 1, 2002).
- 10.6 Asset Purchase Agreement, dated October 31, 2005 between IntraVantage, Inc. (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed November 2, 2005).
- 10.7 Exclusive License Agreement, dated October 31, 2005, between Pro-Dex, Inc. and IntraVantage, Inc. (incorporated herein by reference to Exhibit 10.2 to the Company's Form 8-K filed November 2, 2005).
- 10.8 Royalty Agreement, dated October 31, 2005, between Pro-Dex, Inc. and IntraVantage, Inc. (incorporated herein by reference to Exhibit 10.3 to the Company's Form 8-K filed November 2, 2005).
- 10.9 Asset Purchase Agreement, dated January 5, 2006 between Pro-Dex, Astromec, Inc., Astromec, Inc., M.D. Glover, Inc., Malcolm D. Glover, Jr., and Malcolm D. Glover, Sr. (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed January 6, 2006).
- 10.10 Purchase and Sale Agreement and Escrow Instructions, dated January 3, 2006, between Pro-Dex, Inc. and M.D. Glover, Inc. (incorporated herein by reference to Exhibit 10.2 to the Company's Form 8-K filed January 6, 2006).
- 10.11 Term Note, dated January 4, 2006, by Pro-Dex, Inc. and Wells Fargo Bank, National Association (incorporated herein by reference to Exhibit 10.3 to the Company's Form 8-K filed January 6, 2006).



- 10.12 Loan Agreement, dated January 4, 2006, between Pro-Dex, Inc. and Wells Fargo Bank, National Association (incorporated herein by reference to Exhibit 10.4 to the Company's Form 8-K filed January 6, 2006).
- 10.13 Promissory Note, dated March 4, 2006, effective March 30, 2006, by Pro-Dex, Inc. in favor of Union Bank, National Association (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed April 3, 2006).
- 10.14 Loan Agreement, dated March 4, 2006, effective March 30, 2006, by Pro-Dex, Inc. in favor of Union Bank, National Association (incorporated herein by reference to Exhibit 10.2 to the Company's Form 8-K filed April 3, 2006).
- 10.15\* Employment Agreement with Mark Murphy dated August 14, 2006 (incorporated herein by reference to Exhibit 10.44 to the Company's Form 10-K filed September 28, 2006).
- 10.16 Lease agreement with Irvine Business Properties, dated August 17, 2008 (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed August 23, 2008).
- 10.17\* Letter Agreement with Patrick Johnson dated October 18, 2006 (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed October 24, 2006).
- 10.18 Loan Amendment, dated April 9, 2009, between Pro-Dex, Inc. and Wells Fargo Bank, National Association (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed April 15, 2009).
- 10.19 Loan Amendment, dated June 30, 2009, between Pro-Dex, Inc. and Wells Fargo Bank, National Association (incorporated herein by reference to Exhibit 99.1 to the Company's Form 8-K filed July 6, 2009).
- 21.1 List of Subsidiaries (incorporated herein by reference to Exhibit 21.1 to the Company's Form 10-K filed September 28, 2008).
- 23.1<sup>xx</sup> Consent Letter of Moss Adams LLP.
- 31.1<sup>xx</sup> Certification of the Chief Executive Officer Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2<sup>xx</sup> Certification of the Chief Financial Officer Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32<sup>xx</sup> Certification of the Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\* Denotes management contract or compensatory arrangement required to be filed as an exhibit to the Form 10-K.

<sup>xx</sup> Filed Herewith

SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PRO-DEX INC.

/ s / Mark P. Murphy

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Mark P. Murphy  
President, Chief Executive Officer and Director  
(Principal Executive Officer)

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

/ s / Mark P. Murphy

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Mark P. Murphy  
President, Chief Executive Officer and Director  
(Principal Executive Officer)

September 16, 2009

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Date

/ s / Jeffrey J. Ritchey

-----  
Jeffrey J. Ritchey  
Treasurer, Chief Financial Officer & Secretary  
(Principal Financial and Accounting Officer)

September 16, 2009

-----  
Date

/ s / George J. Isaac

Washington, D.C. 20549

-----  
September 16, 2009  
George J. Isaac  
Director  
-----  
Date

/ s / William L. Healey  
-----  
September 16, 2009  
William L. Healey  
Director  
-----  
Date

/ s / Michael J. Berthelot  
-----  
September 16, 2009  
Michael J. Berthelot  
Director  
-----  
Date

/ s / David Holder  
-----  
September 16, 2009  
David Holder  
Director  
-----  
Date

**End of Filing**