

PRO DEX INC
Form 10QSB
May 15, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-QSB

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

For the quarterly period ended March 31, 2007

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934. FOR THE TRANSITION PERIOD FROM _____ TO _____.

Commission File Number 0-14942

PRO-DEX, INC.

(Exact name of small business issuer as specified in its charter)

Colorado
**(State or Other Jurisdiction of
Incorporation or Organization)**

84-1261240
(IRS Employer Identification No.)

151 E. Columbine Avenue, Santa Ana, California 92707
(Address of Principal Executive Offices)

Issuer's telephone number: 714-241-4411

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

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

Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common equity as of the latest practicable date: 9,636,550 shares of Common Stock, no par value, as of May 12, 2007.

Transitional Small Business Disclosure Format: Yes No

Item 1. Financial Statements**PRO-DEX, INC. and SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS**

	<i>March 31, 2007</i> <i>(unaudited)</i>	<i>June 30, 2006</i> <i>(audited)</i>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 319,000	\$ 358,000
Accounts receivable, net of allowance for doubtful accounts of \$135,000 at March 31 and \$40,000 at June 30	3,525,000	3,841,000
Inventories, net	4,735,000	3,980,000
Prepaid expenses	311,000	91,000
Income tax receivable	354,000	222,000
Deferred income taxes	958,000	766,000
Total current assets	10,202,000	9,258,000
Property, plant, equipment and leasehold improvements, net	3,732,000	3,726,000
Other assets:		
Goodwill	2,997,000	2,931,000
Intangibles - Patents, net	1,345,000	1,417,000
Deferred income taxes	183,000	378,000
Other	37,000	44,000
Total other assets	4,562,000	4,770,000
Total assets	\$ 18,496,000	\$ 17,754,000
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Credit Line	\$ 1,200,000	\$ 900,000
Accounts payable	1,178,000	952,000
Accrued expenses	928,000	971,000
Current portion of term note	250,000	250,000
Current portion of real estate loan	28,000	27,000
Current portion of "patent" deferred payable	82,000	71,000
Total current liabilities	3,666,000	3,171,000
Long-term liabilities		
Term note	458,000	646,000
Real estate loan	1,598,000	1,619,000
Patent deferred payable	158,000	245,000
Total long-term liabilities	2,214,000	2,510,000
Total liabilities	5,880,000	5,681,000
Commitments and contingencies		
Shareholders' equity:		
Common shares; no par value; 50,000,000 shares authorized; 9,551,550 shares issued and outstanding December 31, 2006, 9,539,792 shares issued and outstanding June 30, 2006,	16,268,000	16,066,000
Accumulated deficit	(3,652,000)	(3,993,000)
Total shareholders' equity	12,616,000	12,073,000
Total liabilities and shareholders' equity	\$ 18,496,000	\$ 17,754,000

PRO-DEX, INC. and SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
Three months ended March 31 (unaudited)

	2007	2006
Net sales	\$ 5,916,000	\$ 4,214,000
Cost of sales	3,760,000	2,759,000
Gross profit	2,156,000	1,455,000
Operating expenses:		
Selling	361,000	317,000
General and administrative	780,000	564,000
Research and development	664,000	566,000
Total operating expenses	1,805,000	1,447,000
Income from operations	351,000	8,000
Other income (expense):		
Other (expense), net	(4,000)	-
Royalty income	5,000	5,000
Interest (expense)	(66,000)	(13,000)
Total	(65,000)	(8,000)
Income before provision for income taxes	286,000	-
(Benefit) provision for income taxes	70,000	(6,000)
Net income	\$ 216,000	\$ 6,000
Net Income per share:		
Basic	\$ 0.02	\$ 0.00
Diluted	\$ 0.02	\$ 0.00
Weighted average shares outstanding - basic	9,556,272	9,523,212
Weighted average shares outstanding - diluted	9,765,033	9,998,691

See notes to unaudited consolidated financial statements.

PRO-DEX, INC. and SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
Nine months ended March 31 (unaudited)

	2007	2006
Net sales	\$ 15,780,000	\$ 11,728,000
Cost of sales	10,274,000	6,854,000
Gross profit	5,506,000	4,874,000
Operating expenses:		
Selling	1,039,000	827,000
General and administrative	2,106,000	1,684,000
Research and development	1,890,000	1,451,000
Total operating expenses	5,035,000	3,962,000
Income from operations	471,000	912,000
Other income (expense):		
Other (expense), net	7,000	(7,000)
Royalty income	30,000	42,000
Interest income (expense)	(179,000)	31,000
Total	(142,000)	66,000
Income before provision for income taxes	329,000	978,000
Provision for income taxes	10,000	382,000
Net income	\$ 319,000	\$ 596,000
Net Income per share:		
Basic	\$ 0.03	\$ 0.06
Diluted	\$ 0.03	\$ 0.06
Weighted average shares outstanding - basic	9,549,211	9,490,317
Weighted average shares outstanding - diluted	9,768,277	10,020,766

See notes to unaudited consolidated financial statements.

PRO-DEX, INC. and SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
Nine months ended March (unaudited)

	2007	2006
Cash Flows from Operating Activities:		
Net Income	\$ 319,000	\$ 596,000
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	355,000	302,000
Loss on disposal	5,000	7,000
(Recovery of) Provision for doubtful accounts	95,000	(60,000)
Reserve for obsolete inventory	195,000	267,000
Stock based compensation	199,000	-
Deferred taxes	2,000	(103,000)
Changes in:		
Decrease in accounts receivable	220,000	683,000
(Increase) in inventories	(951,000)	(1,724,000)
(Increase) in prepaid expenses	(220,000)	(107,000)
Decrease (Increase) in other assets	7,000	(19,000)
Increase (Decrease) in accounts payable and accrued expenses	182,000	(79,000)
Increase (Decrease) in income taxes payable	(110,000)	83,000
Net Cash (used in) provided by Operating Activities	298,000	(154,000)
Cash Flows From Investing Activities:		
Acquisition of Astromec, net of assets acquired	-	(2,359,000)
Proceeds from equipment sale	-	1,000
Purchase of equipment and leasehold improvements	(286,000)	(588,000)
Purchase of Intangible Assets - Patents related to Interflow	(68,000)	(1,165,000)
Net Cash (used in) Investing Activities	(354,000)	(4,111,000)
Cash Flows from Financing Activities:		
Principal payments on long-term shareholder borrowings	(96,000)	-
Borrowing on Line of Credit	300,000	1,000,000
Borrowing on Term Note	-	1,000,000
Principal payment on Term Note	(187,000)	(42,000)
Proceeds from option and warrant exercise	-	132,000
Net Cash provided by Financing Activities	17,000	2,090,000
Net (decrease) in Cash and Cash Equivalents	(39,000)	(2,175,000)
Cash and Cash Equivalents, beginning of period	358,000	2,584,000
Cash and Cash Equivalents, end of period	\$ 319,000	\$ 409,000
<i>Supplemental Information</i>		
Cash payments for interest	\$ 180,000	\$ 18,000
Cash payments for income taxes	\$ 137,000	\$ 385,000
<i>Non-Cash Disclosure of Investing and Financing Activities</i>		
Long term payable incurred in acquisition of intangible assets	\$ -	\$ 316,000
Acquisition of building and land - Real Estate Loan	\$ -	\$ 1,650,000
Intravantage Deferred Payable	\$ -	\$ 317,000

See notes to unaudited consolidated financial statements.

PRO-DEX, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements of Pro-Dex, Inc. ("we", "us", "our", "Pro-Dex" or the "Company") have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-QSB and Regulation S-B. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. These consolidated financial statements should be read in conjunction with the audited financial statements presented in our Annual Report for the fiscal year ended June 30, 2006. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. The results of operations for such interim periods are not necessarily indicative of the results that may be expected for the full year. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-KSB for the year ended June 30, 2006.

NOTE 2. INVENTORIES

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

	March 31, 2007 (unaudited)	June 30, 2006
Raw Materials	\$ 2,555,000	\$ 1,694,000
Work in process	816,000	495,000
Development costs under contract	163,000	341,000
Finished goods	2,188,000	2,242,000
Total	\$ 5,722,000	\$ 4,772,000
Reserve for slow moving items	(987,000)	(792,000)
Total inventories, net	\$ 4,735,000	\$ 3,980,000

NOTE 3. GOODWILL

We account for goodwill and other intangible assets in accordance with SFAS No. 142 "Goodwill and Other Intangible Assets." SFAS No. 142 requires that goodwill and other intangible assets with indefinite useful lives no longer be amortized, but instead tested for impairment at least annually in accordance with the provisions of SFAS No. 142.

In accordance with the requirements of SFAS No. 142, we performed impairment tests and recorded no impairment charges in fiscal years ended June 30, 2005 or 2006. We prepare our annual impairment testing on April 1 of each year. Management determined that there were no events or circumstances that have occurred that would indicate an impairment of the goodwill during the nine-month period ended March 31, 2007.

NOTE 4. WARRANTY

The warranty reserve is based on historical costs of warranty repairs and expected future identifiable warranty expenses. We have had warranty expenses in this fiscal year relating to products introduced in the prior fiscal year. At March 31, 2007 we had \$402,000 in accrued warranty reserve, of which, \$124,000 was for known repairs in products returned and in house, and \$278,000 was for future anticipated costs, compared to \$147,000 for known repairs and \$128,000 for future anticipated costs in the March 31, 2006 warranty reserve. Warranty expenses are reflected in the financial statements in cost of sales. The total warranty expense reflected in the cost of sales includes the actual expenditures plus the change in reserve amounts. For the quarter ended March 31, 2007 the warranty expense was \$195,000 and for the nine-months ended March 31, 2007 was \$715,000. The warranty reserve and expenses for the three and nine-months ended March 31, 2007 and 2006 are presented below:

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	Three months Ended March 31,	
	2007	2006
Beginning Balance	\$ 336,000	\$ 85,000
Actual expenditures	\$ (129,000)	\$ (170,000)
Additional accrual/Warranty Expense	\$ 195,000	\$ 360,000
Ending Balance	\$ 402,000	\$ 275,000

	Nine months Ended March 31,	
	2007	2006
Beginning Balance	\$ 309,000	\$ 40,000
Actual expenditures	\$ (622,000)	\$ (316,000)
Additional accrual/Warranty Expense	\$ 715,000	\$ 551,000
Ending Balance	\$ 402,000	\$ 275,000

NOTE 5. NET INCOME PER SHARE

The following table reconciles the weighted average shares outstanding for basic and diluted net income per share for the periods indicated (unaudited).

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	Three Months Ended March 31,	
	2007	2006
Net income	\$ 216,000	\$ 6,000
Basic net income per common share:		
Weighted average number of common shares outstanding	9,556,272	9,523,212
Basic net income per common share	\$ 0.02	\$ 0.00
Diluted net income per share:		
Weighted average of common shares outstanding	9,556,272	9,523,212
Effect of potentially dilutive securities (options)	203,505	444,891
Effect of potentially dilutive securities (warrants)	5,256	30,588
Weighted average number of common shares -		
Diluted	9,765,033	9,998,691
Diluted net income per common share	\$ 0.02	\$ 0.00
	Nine Months Ended March 31,	
	2007	2006
Net income	\$ 319,000	\$ 596,000
Basic net income per common share:		
Weighted average number of common shares outstanding	9,549,211	9,490,317
Basic net income per common share	\$ 0.03	\$ 0.06
Diluted net income per share:		
Weighted average of common shares outstanding	9,549,211	9,490,317
Effect of potentially dilutive securities (options)	211,882	496,673
Effect of potentially dilutive securities (warrants)	7,184	33,776
Weighted average number of common shares -		
Diluted	9,768,277	10,020,766
Diluted net income per common share	\$ 0.03	\$ 0.06

NOTE 6. CREDIT FACILITIES

In November 2006, we renewed our credit facility with Wells Fargo Bank N.A. ("Wells Fargo") for borrowings up to \$2,000,000. Its terms require monthly interest payments at the prime rate of interest (8.25% at March 31, 2007); or LIBOR plus 2.50% (7.875% (one month) to 7.875% (three months) at March 31, 2007), at our discretion, based on outstanding borrowings with no minimum interest charge. There is an annual unused credit line fee of 0.175% calculated and paid quarterly based on the average available unused balance of the credit line. All assets of the Company secure the outstanding borrowings. There was a \$1,200,000 outstanding balance under the terms of this credit facility as of March 31, 2007. The total eligible additional borrowing capacity at March 31, 2007 was \$800,000.

In January 2006, we amended the credit facility and entered into a 4-year term note with Wells Fargo for \$1,000,000. Its terms require monthly interest payments at either the prime rate of interest (8.25% at March 31, 2007); or LIBOR plus 2.50% (7.875% (one month) to 7.875% (three months) at March 31, 2007), at our discretion, based on outstanding borrowings. The principal payments on the note are \$21,000 per month. All assets of the Company secure the outstanding borrowings. There was \$708,000 outstanding balance under the term note as of March 31, 2007.

In March 2006, we entered into a 10-year mortgage with Union Bank of California for \$1,650,000. Its terms require monthly interest payments at a fixed rate of 6.73% based on outstanding borrowings. The principal payments on the mortgage note are based on a 25-year amortization of the note and are \$11,379 per month beginning May 1, 2006. The outstanding borrowings are secured by our Carson City land and building. There was \$1,626,000 outstanding principal balance under the terms of this mortgage as of March 31, 2007.

There are certain financial and non-financial covenants that we must meet to be in compliance with the terms of the Wells Fargo credit facility, which includes the term loan and the line of credit, as amended, and the Union Bank mortgage. March 31, 2007, management believes that the Company was in compliance with all such covenants.

NOTE 7. INCOME TAXES

Deferred income taxes are provided on a liability method whereby deferred tax assets and liabilities are recognized for 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. We have tax credit carry forwards totaling \$124,000 for state tax purposes that do not expire and can be carried forward indefinitely until fully utilized.

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

NOTE 8. STOCK OPTIONS

On July 1, 2006, we adopted 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 requires the measurement and recognition of compensation expense for all share-based payment awards issued to employees and directors based on their estimated fair-value. In March 2006, the SEC issued Staff Accounting Bulletin No. 107 ("SAB 107") relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R). The Company adopted SFAS 123(R) on July 1, 2006 using the modified prospective application transition method. The Company's Consolidated Financial Statements as of and for the three and nine months ended March 31, 2007 reflects the impact of SFAS 123(R). In accordance with this transition method, the Company's Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Share-based compensation expense recognized under SFAS 123(R) for the three and nine months ended March 31, 2007 was \$114,000 and \$199,000, respectively which was related to stock options and restricted stock grants.

SFAS 123(R) requires companies to estimate the fair value of share-based payment awards on the grant-date using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company's Consolidated Statements of Income. Prior to the adoption of SFAS 123(R), the Company accounted for share-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"). Under the intrinsic value method, no share-based compensation expense related to stock options had been recognized in the Company's Consolidated Statements of Operations because the exercise price of the Company's stock options granted to employees and directors equaled the fair market value of the underlying stock at the grant-date.

Share-based compensation expense recognized during the current period is based on the value of the portion of share-based payment awards that is ultimately expected to vest. SFAS 123(R) requires forfeitures to be estimated at the time of grant in order to estimate the amount of share-based awards that will ultimately vest. The forfeiture rate is based on historical rates. Share-based compensation expense recognized in the Company's Consolidated Statements of Income for the three and nine months ended March 31, 2007 includes (i) compensation expense for share-based payment awards granted prior to, but not yet vested as of July 1, 2006, based on the grant-date fair value estimated in accordance with the pro forma provisions of SFAS 123 and (ii) compensation expense for the share-based payment awards granted subsequent to June 30, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123(R). As share-based compensation expense recognized in the Consolidated Statement of Income for the three and nine-month periods ended March 31, 2007 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. In the Company's pro forma information required under SFAS 123 for the periods prior to fiscal 2007, the Company accounted for forfeitures as they occurred.

On November 10, 2005, the Financial Accounting Standards Board ("FASB") issued FASB Staff Position No. SFAS 123(R)-3, "Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards." The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool ("APIC pool") related to the tax effects of employee share-based compensation, and to determine the subsequent impact on the APIC pool and Consolidated Statements of Cash Flows of the tax effects of employee share-based compensation awards that are outstanding upon adoption of SFAS 123(R). The Company has elected to adopt the provisions of SFAS 123(R)-3.

The Board of Directors and the shareholders of the Company have approved and adopted two equity based compensation plans, pursuant to which options to purchase an aggregate of 2,500,000 shares of common stock may be granted to officers, directors, and employees of the Company. The 2004 Employee's Plan ("Employee's Plan") authorizes 2,000,000 options to purchase shares and the 2004 Director's Plan ("Director's Plan") authorizes 500,000 options to purchase shares. Option awards are generally made with an exercise price equal to the market price of our stock at the date of the grant, and generally fully vest after 6 months of continuous service for directors and incrementally vest over 3 to 5 years of continuous service for employees. Both plans have a 10-year term and expire in 2014. The aggregate compensation cost that has been charged against income for those plans was \$114,000 for the quarter ended March 31, 2007.

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There are 427,045 shares available to grant under the Employee's Plan, and 195,000 shares available to grant remaining under the Director's Plan - for a total of 622,045 shares remaining under both option plans at March 31, 2007. Transactions involving the Company's stock options for the nine months March 31, 2007 are summarized as follows:

Options	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at 6/30/2006	1,204,316	\$ 1.68		
Granted	411,000	1.41		
Exercised	(110,000)	1.24		
Forfeited	(205,000)	2.62		
Outstanding at 3/31/2007	1,300,316	\$ 1.49	6.53	\$ 445,040
Exercisable at 3/31/2007	935,566	\$ 1.42	5.37	\$ 364,040

A summary of the status of our nonvested shares as of March 31, 2007 and changes during the nine-months ended March 31, 2007 is presented below:

Nonvested Shares	Shares	Weighted-Average Grant-Date Fair Value
Nonvested at 6/30/2006	263,750	\$ 2.44
Granted	411,000	1.40
Vested	(100,000)	1.96
Vested and Exercised	(90,000)	1.34
Forfeited	(120,000)	2.74
Nonvested at 3/31/2007	364,750	\$ 1.58

During the quarter ended March 31, 2007, the Company granted no options to purchase shares of its common stock under the Director's Plan and no options to purchase shares of its common stock under the Employee's Plan.

During the nine months ended March 31, 2007, the Company granted options to purchase 45,000 shares of its common stock under the Director's Plan exercisable at an average per share price of \$1.52 (fair value \$0.88 per option) and options to purchase 26,000 shares of its common stock under the Employee's Plan exercisable at an average per share price of \$1.53 (fair value \$1.03 per option).

The fair value of each grant is estimated at the grant date using the Black-Scholes option-pricing model with the following assumptions: no dividend rate for all years; price volatility of 54% to 63%, risk-free interest rate of approximately 4.7% to 5.1%. The risk free rate is based on the applicable U.S. Treasury yield curve in effect on the date of the grant. Expected volatility is based on the changes in the historical monthly closing prices of the shares. The assumed expected lives are between 5.25 to 7.5 years and based for each grant on the simplified calculation method.

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During the nine months ended March 31, 2007, the Company granted 450,000 Stock Appreciation Rights ("SAR's") possessing an average benchmark per share price of \$1.53 (fair value \$0.67 per SAR). In February 2007, these SAR's were exchanged for 340,000 shares of restricted stock. The value of each share of restricted stock was \$1.38, based on the closing market price of the underlying Common Stock price on the grant date. The restricted stock vests in equal annual installments over four years, with the first vesting of 25% of the shares at the date of grant on February 21, 2007, 25% on each of the following three anniversaries of the grant. The net compensation cost that was charged against income for the restricted stock grant was \$94,000 for the three and nine months ended March 31, 2007.

The fair market value of each SAR was estimated at the grant date using the Black-Scholes option-pricing model with the following assumptions: no dividend rate for all years; price volatility of 51% to 56%, risk-free interest rate of approximately 4.7%; and expected life of 3 to 4 years. The compensation cost that was charged against income for the SAR was \$33,000 for the six months ended December 31, 2006. This amount was reversed in the quarter ending March 31, 2007. There was no remaining market value of each SAR at March 31, 2007.

As of March 31, 2007, there was \$409,000 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Employee's and Director's Plans and the restricted stock grants. The cost is expected to be recognized over the vesting periods determined by the grants of no greater than four years on a straight-line basis for the options and three additional years for the restricted stock grants. None of the compensation cost is capitalized in the cost of the assets of the Company.

Share-based compensation expense reduced the Company's results of operations as follows:

	Nine months Ended March 31, 2007	Three months Ended March 31, 2007
Share based compensation expense	\$199,000	\$114,000

The following table illustrates the effect on net income and earnings per share for the three and the nine months ended March 31, 2006, as if the Company had applied the fair value recognition provisions of SFAS 123, as amended by SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure" ("SFAS 148"):

	Nine Months Ended March 31, 2006	Three Months Ended March 31, 2006
Net income as reported:	\$ 596,000	\$ 6,000
(Deduct) total stock-based employee and director compensation expense determined under fair value based method for all awards, net of related tax effects	(43,000)	(14,000)
Pro-forma net income:	\$ 553,000	\$ (8,000)
Basic earnings per share	As reported \$ 0.06	As reported \$ 0.00
Diluted earnings per share:	As reported \$ 0.06	As reported \$ 0.00
	Pro-forma \$ 0.06	Pro-forma \$ (0.00)

NOTE 9. MAJOR CUSTOMERS

The Company had two major customers (defined as a customer that represents greater than 10% of the Company's total revenues) in the nine months ended March 31, 2007 and 2006.

	Revenues			Revenues		
	Nine Months	Three Months	Accts. Rec.	Nine Months	Three Months	Accts. Rec.
	Ended March 31, 2007			Ended March 31, 2006		
Customer 1	\$ 3,350,000	\$ 1,722,000	\$ 1,059,000	\$ 2,909,000	\$ 469,000	\$ 575,000
Customer 2	\$ 3,115,000	\$ 1,058,000	\$ 476,000	\$ 1,505,000	\$ 594,000	\$ 16,000

NOTE 10. COMMITMENTS AND CONTINGENCIES

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. In many cases, the exposure to the company is limited by insurance covering the potential damages associated with litigation. Management is not aware of any material actual, pending or threatened litigation at this time.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**COMPANY OVERVIEW**

The following discussion and analysis provides information that the Company's management believes is relevant to an assessment and understanding of our results of operations and financial condition for each of the nine and three month periods ended March 31, 2007 and 2006, 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. Our critical accounting policies relate to inventory valuation for slow moving items, impairment of goodwill, and recoverability of deferred income taxes.

Except for the historical information contained herein, the matters discussed in this Quarterly Report on Form 10-QSB, including discussions of our product development plans, business strategies and market factors influencing our results, are forward-looking statements that involve certain risks and uncertainties. Actual results may differ from those anticipated by us as a result of various factors, both foreseen and unforeseen, including, but not limited to, our ability to continue to develop new products and increase systems sales in markets characterized by rapid technological evolution, consolidation within our target marketplace and among our competitors, and competition from larger, better capitalized competitors. Many other economic, competitive, governmental and technological factors could impact our ability to achieve our goals. Interested persons are urged to review the risks described herein, as well as in our other public disclosures and filings with the Securities and Exchange Commission. We refer you to the risk factors and cautionary language contained in our reports filed with the Securities and Exchange Commission from time to time, including, but not limited to, those risks and uncertainties which may be listed in our Annual Report on Form 10-KSB.

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Pro-Dex, Inc. ("Company," "Pro-Dex", "we," "our," "us"), with operations in Santa Ana, California, Beaverton, Oregon and Carson City, Nevada, specializes in bringing speed to market in the development and manufacture of technology-based solutions that incorporate embedded motion control, miniature rotary drive systems 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. 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 151 E. Columbine Avenue, Santa Ana, California 92707 and our phone number is 714-241-4411. Our Internet address is www.pro-dex.com. Our annual reports on Form 10-KSB, quarterly reports on Form 10-QSB, current reports on Form 8-K, amendments to those reports and other Securities and Exchange Commission ("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.

Description of Business

The majority of our revenue is derived from designing, developing and manufacturing electric, air, and battery powered 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 the aerospace and medical industries. The Company distributes its own line of pneumatic and electric dental hand pieces sold under the Micro Motors name utilizing a network of independent sales representatives across North America. Historically, a large part of the revenue growth of the Company has been driven by developing and selling numerous private label rotary drive systems for use in dental, cranial, spinal, arthroscopic and orthopedic surgery. Other revenue sources include designing and manufacturing miniature pneumatic motors in the aerospace and apparel industries.

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

Company-funded research and development supports the development of generic rotary drive and motion control platforms. We then seek customer-funded projects to customize these platforms to specific customer requirements. Company-funded research and development projects are generally expected to convert to customer-funded projects within six to eighteen months. Company funded project costs are expensed as incurred. In the three months ended March 31, 2007, \$664,000 was expensed; an increase of \$98,000 or 17%, from the \$566,000 expensed in the three months ended March 31, 2006. The increase is attributable to the expensing of previously capitalized product development cost.

Customer-funded research and development provided no revenue in the three months ended March 31, 2007, and \$10,000 in revenue in the three months ended March 31, 2006, reflecting no development fees billable during the quarter as engineering efforts were focused on pre-contract development work, as well as on upgrading current products and supporting warranty work. The results of customer-funded development work are intended to provide long-term exclusive manufacturing agreements and provide the customer with the retention of the specified intellectual property developed. The identity of the customer is generally protected by a non-disclosure agreement.

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For customer-funded development projects, costs are capitalized and recognized as a cost of sales when specific deliverables within the development contracts are produced, matching the costs to the revenue. In the three months ended March 31, 2007, \$15,000 was recognized as cost of sales, compared to \$27,000 recognized as cost of sales in the three months ended March 31, 2006, reflecting an increase in deliveries of the products associated with prior development projects.

The Company's revenue is derived from five main customer types. The proportion of Pro-Dex total sales to each customer type is noted in the table below:

Sales by customer type (\$'000)	Three months Ended March 31,				Nine months Ended March 31,			
	2007		2006		2007		2006	
	Dental	\$ 1,466	25%	\$ 1,011	24%	\$ 3,653	23%	\$ 2,815
Medical*	\$ 2,488	42%	\$ 1,306	31%	\$ 6,340	40%	\$ 4,926	42%
Industrial	\$ 758	13%	\$ 801	19%	\$ 2,518	16%	\$ 2,228	19%
Aerospace*	\$ 633	11%	\$ 586	14%	\$ 1,794	11%	\$ 586	5%
Government, repairs and other	\$ 571	10%	\$ 510	12%	\$ 1,475	9%	\$ 1,173	10%
Total Sales	\$ 5,916	100%	\$ 4,214	100%	\$ 15,780	100%	\$ 11,728	100%

Sales by location (\$'000)	Three Months Ended March 31,				Nine Months Ended March 31,			
	2007		2006		2007		2006	
	Santa Ana	\$ 4,034	\$ 2,302	\$ 10,060	\$ 8,370			
Beaverton	1,007	1,100	3,068	2,546				
Carson City*	875	812	2,652	812				
Total Sales	\$ 5,916	\$ 4,214	\$ 15,780	\$ 11,728				

*Pro-Dex Astromec's sales are primarily to the aerospace and medical markets and became a part of Pro-Dex with the acquisition of substantially all of Astromec's assets in January 2006.

Medical product sales represent the manufacture of products that utilize proprietary designs developed by the Company under exclusive design and supply agreements. Our dental products are sold to original equipment manufacturers and dental product distributors. An independent dealer network markets our own branded line of dental products, including Intraflow. We also design and manufacture embedded multi-axis motion controllers used to regulate the motion of servo and stepper motors, predominantly for the semiconductor, factory automation and medical analysis equipment industries. The controllers support the platforms for PCI, VME, ISA, and cPCI busses as well as stand-alone requirements. In addition, we make and sell pneumatic motors for industrial applications that are marketed directly to end-users and through industrial supply distributors. We added significant sales to the aerospace market with the purchase of the Astromec assets and establishing Pro-Dex Astromec in January 2006. The Pro-Dex Astromec products include highly reliable fractional horsepower DC motors designed for harsh environments.

We hold the following three independently verified certifications: ISO 9001:2000, ISO 13485 revised 1998, and Medical Device Directive 93/42/EEC Annex II company.

At the present time, we are generally able to fill orders within sixty (60) days. At March 31, 2007, we had a backlog, including orders for delivery beyond 60 days, of \$9.3 million compared with a backlog of \$10.7 million at March 31, 2006. We expect to ship our entire backlog in the remainder of fiscal year 2007 and in fiscal year 2008. The decreased backlog compared to March 31, 2006 is due to the high level of sales in the current quarter that have not yet been replaced with new 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.

We sell our products using several methods; selling directly to the customer, selling directly to original equipment manufacturers and selling through a network of high technology and dental product distributors within North America. Internationally, the Company has sales agreements with foreign distributors or sells through the domestic subsidiaries of foreign customers.

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 and estimates 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, valuation of goodwill and other intangible assets, and the recoverability of deferred income tax assets.

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

We determine our inventory value at the lower of cost (first-in, first-out method) or market value and calculate a reserve for slow moving items to reflect a reduced marketability for the item. The reserve is calculated by comparing the quantity of the item on hand with our prior 12-month sales history. If inventory on hand for a specific part exceeds an estimated 24 months of usage, between 20% and 100% of its value may be included in the inventory reserve. The actual percentage reserved depends on the total quantity on hand, its sales history, and expected near term sales prospects.

The majority of our products have a twelve-month warranty. We determine our warranty reserve by considering the historical costs to repair warranty eligible products and by estimating the number and type of products that may be eligible for warranty return and repair. We determine our reserve by calculating a cost estimate based on what products are known to be warranty-eligible, have been returned and are in process of being repaired and combining it with an expected cost for units in the field that have a potential to be returned for warranty-eligible repair. The potential return amount is based on historical and estimated return and repair cost data. At March 31, 2007 we had \$402,000 in accrued warranty reserve, of which, \$124,000 was for known repairs in products returned and in house, and \$278,000 for future anticipated costs, compared to \$147,000 for known repairs and \$128,000 for future anticipated costs in the March 31, 2006 warranty reserve. The reserve amount for products in the field expected to be returned has grown due to the higher rates of return realized as the product line aged that was higher than previously estimated.

Warranty Reserve (\$'000)	3/31/2007	6/30/2006	3/31/2006
In house	\$ 124	\$ 139	\$ 147
In field	278	170	128
Total Accrual	\$ 402	\$ 309	\$ 275

We account for goodwill and other intangible assets in accordance with SFAS No. 142 "Goodwill and Other Intangible Assets." SFAS No. 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but tested for impairment at least annually. We have recorded no impairment charge in 2005 or 2006. We prepare our annual impairment testing as of April 1 of each year.

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 that are included within the consolidated balance sheet. The most significant deferred tax assets are future deductions from the amortization of intangibles over the next ten years; deferred 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 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.

We account for share-based payment awards in accordance with SFAS 123(R) which requires companies to estimate the fair value of share-based payment awards on the grant-date using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company's Consolidated Statements of Operations. Prior to the adoption of SFAS 123(R), the Company accounted for share-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"). Under the intrinsic value method, no share-based compensation expense related to stock options had been recognized in the Company's Consolidated Statements of Operations because the exercise price of the Company's stock options granted to employees and directors equaled the fair market value of the underlying stock at the grant-date.

RESULTS OF OPERATIONS

For the Three-Month periods ended March 31, 2007 and 2006

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The following table sets forth for the periods indicated the percentage of net revenues represented by each item in our Consolidated Statements of Income.

(In Thousands)	Three Months Ended March 31,			
	2007		2006	
Net sales:	\$ 5,916	100.0%	\$ 4,214	100.0%
Cost of sales	3,760	63.6%	2,759	65.5%
Gross Profit	2,156	36.4%	1,455	34.5%
Selling, general and administrative expenses	1,140	19.3%	881	20.9%
Research and development costs	664	11.2%	566	13.4%
Income from Operations	352	5.9%	8	0.2%
Net interest and other income	(66)	(1.1%)	(8)	(0.2%)