PRO DEX INC
Form 10KSB
September 22, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-KSB

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

For the fiscal year ended June 30, 2008

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

PRO-DEX, INC.

(Name of small business issuer in its charter)

Colorado	**84-1261240**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

2361 McGaw Avenue, Irvine, California	**92614**
(Address of principal executive offices)	**(Zip Code)**

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

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

Title of each class	**Name of each exchange on which registered**
Common Stock, no par Value	**NASDAQ Capital 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. [ ]

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 [X] 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-KSB or any amendment to this Form 10-KSB. [X]

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

Yes [ ] No [X]

State issuer's revenues for its most recent fiscal year: $25,126,000.

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 September 16, 2008: $5,297,297. 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: 9,767,866 shares of Common Stock, no par value, as of September 16, 2008.

DOCUMENTS INCORPORATED BY REFERENCE: Part III incorporates by reference certain information from the registrant's definitive proxy statement (the "Proxy Statement") for the 2008 Annual Meeting of Shareholders.

Transitional Small Business Disclosure Format: Yes [ ] No [X]

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-KSB, 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, 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. Description of Business

Company Overview

Pro-Dex, Inc. (Company, Pro-Dex , we, our, , us), with operations in Irvine, California, Beaverton, Oregon and C 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 recently moved and are now located at 2361 McGaw Avenue, Irvine, California 92614 and our phone number also changed to 949-769-3200. 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 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.

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, cranial, spinal, arthroscopic and orthopedic surgery. 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. Other revenue sources include designing and manufacturing miniature pneumatic motors, fractional horsepower DC motors and motion control systems for industrial applications in the 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.

In the year ended June 30, 2008, $2,732,000 was expensed for company-funded research and development; an increase of $258,000 from the $2,474,000 expensed in the year ended June 30, 2007. The increase was attributable to increased labor costs for medical and small motor product development, improvement and validation.

We seek customer-funded projects to customize these 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. 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 certain parts of the intellectual property developed. The identity of our customers is generally protected by a non-disclosure agreement.

Customer-funded development ($'000)	Year Ended June 30, 2008		2007	
Revenue	$ 470		$ (24)	
Cost of Sales	119		124	
Gross margin	$ 351	75%	$ (148)	- -

In fiscal year 2008, there was a $494,000 increase in revenue from customer-funded research and development as there was work performed on three major new development projects that were started in 2008 compared to $24,000 in negative revenue from customer-funded research and development as fees were refunded due to cancelled development projects in the year ended June 30, 2007.

The Company s 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)	2008		2007*		2006		2005		2004	
Dental	$3,290	13%	$3,476	16%	$3,789	22%	$3,368	24%	$4,578	32%
Medical	14,121	56%	10,275	48%	6,447	38%	5,849	42%	5,864	41%
Industrial	3,279	13%	3,317	15%	3,753	22%	3,570	26%	2,533	18%
Aerospace	2,382	9%	2,445	11%	1,194	7%	--	--	--	--
Repairs, Government and other	2,054	8%	2,050	10%	1,878	11%	1,047	8%	1,225	9%
Total Sales	$25,126	100%	$21,563	100%	$17,061	100%	$13,834	100%	$14,200	100%

*Sales to customer types for 2007 have been changed for dental & medical to reflect current classifications.

Sales by location ($'000)	2008		2007		2006		2005		2004	
Irvine	$ 18,268	73%	$ 13,852	64%	$ 10,823	63%	$ 9,946	72%	$ 10,900	77%
Beaverton	3,443	14%	4,121	19%	4,585	27%	3,888	28%	3,300	23%
Carson City	3,453	14%	3,590	17%	1,653	10%	-	-	-	-
Interlocation sales	(38)	0%	-	-	-	-	-	-	-	-
Total Sales	$ 25,126	100%	$ 21,563	100%	$ 17,061	100%	$ 13,834	100%	$ 14,200	100%

Medical product sales represent the manufacture of 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. An independent dealer network markets our own branded line of dental products; including the Intraflow™ dental anesthesia product that we acquired the rights to in October 2005. We also 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. 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 sales with the purchase of the assets of Astromec, Inc. in Carson City, Nevada, and the establishment of Pro-Dex Astromec, Inc. in January 2006. The Carson City products include high reliability fractional horsepower DC motors designed for harsh environments, primarily for the aerospace and medical markets.

In 2008, the top 20 customers accounted for 81% of our sales, compared to 77% in 2007. In 2008, our two largest customers accounted for 50% of such sales with the largest customer accounting for over 32% of our sales. This compares to 2007 when our two largest customers accounted for 41% of our sales with the largest customer accounting for 23% of such sales. Some of our larger customers include Smith and Nephew, Medtronic, Sullivan Schein, Thermo Fisher Scientific, Monogram, and Benchmark Electronics. In many cases, disclosure of other larger 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.

All of the raw materials used to manufacture our products are 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 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. We have no exclusive arrangements with any of our suppliers.

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, 2008, we had a backlog, including orders for delivery beyond 60 days, of $10.4 million compared with a backlog of $10.1 million at June 30, 2007. We expect to ship most of our backlog in fiscal year 2009 and the remainder in fiscal year 2010. The decrease from June 2007 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.

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

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. The net amounts spent on company-funded research and development activities in 2008 and 2007 were approximately $2.7 million and $2.5 million, respectively. 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.

We 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.

Employees

At June 30, 2008, we had 145 full-time employees compared to 124 full-time employees at June 30, 2007. 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. At June 30, 2007, there were 86 persons employed at the Santa Ana location, 26 persons employed at the Carson City location and 12 persons employed at the Beaverton location. We use temporary staffing as a temp-to hire recruiting strategy as well as to add flexibility in meeting our production, engineering and office staffing needs. The use of temporary labor from temporary staffing agencies was reduced as we employed 4 agency temps at June 30, 2008, down from 7 agency temps at June 30, 2007.

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 is neither infringed upon by any third party, nor infringes upon any prior art of any third party. 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.

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; 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 variations 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 healthcare, factory automation and small motor products and 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 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.

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 would 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.

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-KSB for the fiscal year ending June 30, 2008. 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.

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 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.

Our 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. 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, financial condition, and our ability to remain listed as a publicly held exchange traded company.

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 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 $31,000 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 $6,060 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. 169th Place, Building C100, Beaverton Oregon 97006.

Our Pro-Dex Astromec office and manufacturing facility is located at 2950 Arrowhead Drive, Carson City, NV 89708. We purchased 4.4 acres of real property and a 20,000 square foot industrial building and related improvements located in Carson City, Nevada 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 of California, whereby we borrowed $1,650,000. This loan is secured by the land and building in Carson City, Nevada.

The principal balance of the Union Bank loan evidenced by the Promissory Note bears interest at a fixed rate of 6.73% per annum. Under the terms of the Promissory Note, the Union Bank loan amortizes as a 25 year obligation due in 10 years with 120 equal monthly payments of $11,379 beginning May 1, 2006. The maximum amount of future payments due under the Promissory Note (undiscounted and assuming no prepayment) is $2,380,538.

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

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, etal., 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.

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 may be 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 uncertain event that Pro-Dex 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.

Because of the vagueness of the complaint, the early stage of the OCWD s remedial activities in the South Basin, and the likelihood that any recovery the OCWD may gain will be allocated among several defendants, our liability, 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, 2008.

PART II

Item 5. Market for Common Equity, Related Stockholder Matters and Small Business 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 16, 2008, the last sale price of our common stock as reported by NASDAQ was $0.81 per share.

Quarter Ended	High	Low
September 30, 2006	1.75	1.32
December 31, 2006	1.57	1.16
March 31, 2007	1.50	1.23
June 30, 2007	1.68	1.31
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

At June 30, 2008, there were approximately 260 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, 2008 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 services reflected in column (a))
	(a)	(b)	(c)
Plans Approved by Stockholders	1,279,500	$1.56	476,045
Plans Not Approved by Stockholders	100,000	1.25	---
Total	1,379,500	$1.53	476,045

We made no repurchases of our securities during the fourth quarter and year of the year ended June 30, 2008.

The stock repurchase was reconfirmed by our Board of Directors in July 2008. In the period subsequent to June 30, 2008 through September 16, 2008, we repurchased 35,500 shares for $33,575 at an average price of $0.95 per share. Since the initiation of the buyback in 2002 through September 16, 2008, we have repurchased 111,200 shares for $77,316 at an average price of $0.69 per share.

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Item 6. Management's Discussion and Analysis or Plan of Operation

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, 2008 and 2007, 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.

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 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 for each specific part number. If inventory on hand for a specific part exceeds an estimated 12 months of usage or orders on hand, 100% of its value is included in the inventory reserve as it s carrying value is reduced to the lower of cost or market value.

We determine the reserve for our accounts receivable by examining the aging of the receivables value. We define aging as time passed since the sale was completed, revenue was recognized and the receivable was established. If the receivable is aged over 90 days, 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 majority of our products have a twelve month warranty. We determine our warranty reserve based on considering the historical costs to repair warranty-eligible products and by estimating the number and type of products that may be eligible for future 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 return and repair cost data. At June 30, 2008 we had $861,000 in accrued warranty reserves, as compared to $469,000 in accrued warranty reserves at June 30, 2007. The increase is due to the much higher shipment levels in the warranty- eligible product line in 2008 as compared to 2007, coupled with a slightly higher assumed return rate.

The Company accounts for goodwill under 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 instead tested for impairment at least annually in accordance with the provisions of SFAS No. 142. We have recorded no impairment charge in fiscal 2008 or 2007. We prepare our annual impairment testing on April 1 of each year.

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 a small business issuer, the statement was effective for us at the beginning of the first fiscal year that begins after December 15, 2005, which was our fiscal year ended June 30, 2007.

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. 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 our estimates of future taxable income by jurisdiction in which we operate 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.

Year in Review

Fiscal year 2008 was a year of continued growth and improvement at Pro-Dex, continuing the initiatives and improvements that were made in 2007. We grew our sales by over 16% over fiscal year 2007 and have more than doubled sales in the five years since fiscal year 2003. The sales growth can be attributed to both organic growth, as our medical products have been favorably accepted by the market, and acquisitive growth as the Pro-Dex Astromec business added over $3.4 million to our revenues in both 2007 and 2008. In 2008 we initiated three new major development projects, each proving different growth opportunities for our business model, and with an opportunity of providing meaningful revenues in the second half of fiscal year 2009 and beyond. One project is with a new customer, and involves significant pre-launch engineering and engineering development fees. The second is with a customer that we developed the FDA qualification units for a few years ago and now we have been selected to develop and produce the higher volume production units. The third is with a continuing customer as we design their next generation surgical system.

We strengthened the Company s infrastructure by moving the physical locations of both our Beaverton and the Southern California operations to new facilities. The Beaverton facility moved at the end of December 2007 into a smaller workspace more amenable to their engineering and development efforts. At the end of April, 2008, the Southern California facility moved from its longstanding location in Santa Ana to a facility in Irvine. The move to Irvine was not an inexpensive proposition, but necessary due to the constraints of the facility that Pro-Dex and its predecessor company Micro Motors had occupied since the 1970 s. The facility is over 50% larger, and we were able to lay it out in a way that has already significantly contributed toward providing for an efficient collaborative culture with the necessary space to serve our customers as a larger, more efficient company.

We maintained the Company s strong financial position by generating over $2.0 million in operating cash for the 2008 fiscal year. We increased our borrowing capacity by raising our credit line availability from $2.0 million to $4.0 million and establishing an additional $2.0 million availability to fund our tenant improvements. By remaining profitable, we increased our tangible net worth per share by 6% from $0.88 per share to $0.93 per share.

Our operating margins were adversely affected, in part by the change in our inventory reserve estimate, negatively impacting margins by $301,000 in the third quarter. Another factor impacting margins was our sales mix, which had a decline in industrial/motion control sales, as compared to 2007. Finally, we completed our major facilities move in the fourth quarter, adding $274,000 in move costs, an estimated $225,000 in manufacturing inefficiencies.

As we enter fiscal 2009, we are seeing that the results of the efforts to improve and grow the Company are paying off in improved product quality, better designs and more efficient manufacturing. We remain committed to changing the direction of the Company to provide a higher level of earnings in the coming years and have continued to transition Pro-Dex to a better, stronger, faster company.

RESULTS OF OPERATIONS

Results of Operations for Fiscal Year Ended June 30, 2008, Compared to Fiscal Year Ended June 30, 2007

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,			
	2008		2007	
Net sales:	$ 25,126	100.0%	$ 21,563	100.0%
Cost of sales	16,917	67.3%	14,196	65.8%
Gross Profit	8,209	32.7%	7,367	34.2%
Selling, general and administrative expenses	5,021	20.0%	4,051	18.8%
Research and development costs	2,732	10.9%	2,474	11.5%
Income from Operations	456	1.8%	842	3.9%
Net interest and other (income)	138	0.5%	267	1.2%
Provision for Income Taxes	1	0.0%	69	0.3%
Net Income	$ 317	1.3%	$ 506	2.3%

Net Sales. Consolidated sales increased 17% or $3,563,000 to $25,126,000 from $21,563,000 for 2008 as compared to 2007. Medical sales were higher by $3,846,000 or 37%, due to higher sales to our two largest customers by $3,803,000. Shipments to dental customers decreased by $186,000 or 5%. Sales to industrial customers were essentially flat, showing a small decrease of $38,000 or 1% from the same period in the prior year. Sales related to government research related products and product repairs, were also stable, with a year over year increase of $4,000 as the increase in repair and upgrade work for products that were not warranty eligible offset the decline in government agency related work.

In fiscal year 2008, there was a $494,000 increase in revenue from customer-funded research and development as there was work performed on three major new development projects that were started in 2008 compared to $24,000 in negative revenue from customer-funded research and development as fees were refunded due to cancelled development projects in the year ended June 30, 2007.

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:

	Fiscal Year ended June 30,		Increase/
Sales by customer type ($'000)	2008	2007	(Decrease)
Dental	$ 3,290	$ 3,476	-5%
Medical	14,121	10,275	37%
Industrial	3,279	3,317	-1%
Aerospace	2,382	2,445	-3%
Government research and other	2,054	2,050	0%
Total	$ 25,126	$ 21,563	17%

Gross Profit The Company's consolidated gross profit for 2008 increased $841,000 or 11% compared to the gross profit in the previous year due to the higher medical product sales level. Gross profit as a percentage of sales decreased to 33% for the year ended June 30, 2008 compared to 34% for the year ended June 30, 2007. Gross margin as a percentage of sales was negatively impacted by inefficiencies introduced in the Irvine facility move, and an inventory reserve estimate change that impacted margins in unfavorably by $301,000. Gross profit and gross profit percentage were as follows:

	Fiscal Year ended June 30,			
	2008		2007	Increase
Gross Profit	$	8,209,000	$ 7,367,000	11%
Gross Profit Percentage of Sales	33%		34%	

Selling, general and administrative costs (S, G&A). S, G & A expenses increased 18% to $5,021,000 for the year ended June 30, 2008 from $4,051,000 for year ended June 30, 2007. The increase in selling expense is mainly due to increased labor expenditures. General and administrative costs were higher primarily due to move related costs and increased labor and IT related expenses. As a percentage of sales, S, G&A costs increased from 19% to 20%. S, G & A costs were as follows:

	Fiscal Year ended June 30,				
	2008		2007		Increase
Selling	$	1,482,000	$	1,352,000	10%
General and administrative	$	3,539,000	$	2,699,000	31%
Total S, G&A	$	5,021,000	$	4,051,000	24%
S, G&A Percentage of Sales	20%		19%		

Research and development costs. Company funded research and development expenses increased $258,000 to $2,732,000 for the year ended June 30, 2008 from $2,474,000 for the year ended June 30, 2007, an increase of 10%. The increase was due to higher labor related costs at the Carson City and Irvine operations offset by reduced outside consultant cost. Company-funded research and development costs were as follows:

	Fiscal Year ended June 30,				
	2008		2007		Increase
Research and Development (R&D) Costs	$	2,732,000	$	2,474,000	10%
R&D costs as a % of Sales	11%		15%		

Operating Profit and Operating Profit as a Percentage of Sales. Our consolidated operating profit for the year ended June 30, 2008 decreased to $456,000 from an operating profit of $842,000 for the year ended June 30, 2007. Consequently, operating profit as a percentage of sales decreased to 2% for the year ended June 30, 2008 compared to 4% for the year ended June 30, 2007. Operating profit and margin were as follows:

	Fiscal Year ended June 30,		
	2008	2007	(Decrease)
Operating Profit	$ 456,000	$ 842,000	(46%)
Operating profit Percentage of Sales	2%	4%	

Royalties and Other Income. We earned and received $35,000 in royalty payments in fiscal year 2008, compared to $38,000 in royalty payments in 2007. There was $9,000 in other expense for asset abandonment associated with the move.

Net Interest Income/Expense. Net interest expense was $164,000 in the year ended June 30, 2008, which included $181,000 in interest expense offset by $17,000 in interest income, compared to $301,000 which included $319,000 in interest expense offset by $18,000 in interest income, in the prior year.

The decrease in interest expense is due to lower interest rates offsetting higher borrowing requirements, and the early prepayment of most of the obligations associated with the Intravantage deferred payable. Included in the $164,000 from 2008 and in the $301,000 from 2007 is $15,000 and $68,000 respectively in accrued interest relating to the ongoing IRS examination for the tax years ending June 30, 2004, 2005 and 2006.

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