

PRO DEX INC
Form 10KSB
September 22, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-KSB

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

**(State or other jurisdiction of
incorporation or organization)**

84-1261240

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

UNITED STATES

2361 McGaw Avenue, Irvine, California
(Address of principal executive offices)

92614
(Zip Code)

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

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

| <u>Title of each class</u> | <u>Name of each exchange on which registered</u> |
|----------------------------|--|
| 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 [] 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. []

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

Yes [] No []

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.

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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 Clatsop 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.

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| 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.

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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.

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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, et al., Case No 00078246. The South Basin underlies parts of Santa Ana, California and adjacent cities. The complaint identifies 17 named defendants, including Pro-Dex, and also designates 400 unnamed Doe defendants.

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 | 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)) |
|------------------------------------|---|---|--|
| Plan Category | (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.

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 its 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:

| Sales by customer type (\$'000) | Fiscal Year ended June 30, | | Increase/ (Decrease) |
|---------------------------------|----------------------------|-----------|-------------------------|
| | 2008 | 2007 | |
| 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.

| | Fiscal Year ended June 30, | | |
|--------------------------------------|----------------------------|-------------|----------|
| | 2008 | 2007 | Decrease |
| Debt related interest expense | \$ 166,000 | \$ 251,000 | (34%) |
| IRS exam related interest | \$ 15,000 | \$ 68,000 | (78%) |
| Total interest expense | \$ 181,000 | \$ 319,000 | (43%) |
| Interest income | \$ (17,000) | \$ (18,000) | (6%) |
| Net interest expense | \$ 164,000 | \$ 301,000 | (46%) |
| Interest expense Percentage of Sales | 1% | 1% | |

Income Tax Provision. Our effective income tax rate was 0% for the year ended June 30, 2008, compared to 12% for the year ended June 30, 2007. Our effective income tax rate in 2008 decreased from 2007 primarily due to the realization of a fixed amount of research and development tax credits.

The Company is undergoing an examination by the Internal Revenue Service (IRS) of its Federal income tax returns filed for the fiscal years ending June 30, 2004, June 30, 2005 and June 30, 2006. Findings of the examination indicate that there may have been differences in the timing of our tax payments due to the treatment of inventory uniform capitalization rules. As a result of the examination, we paid approximately \$179,000 of additional tax payments in May 2008. Subsequent to year end, we received a final interest invoice and paid \$31,000 of interest to the IRS. The interest amounts have been accrued and are included in accrued expenses and interest as of June 30, 2008. Although we have not received a final audit closing notification, we do not believe there will be any material adjustments resulting from the examination beyond those described above.

As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax liabilities together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. The deferred tax assets result primarily from tax basis of intangible assets in excess of

book basis. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent management believes that recovery is not likely, we must establish a valuation allowance. To the extent a valuation allowance is either increased or decreased in a period, the impact will be included in the tax provision in the statement of operations.

Net Income. We had net income of \$317,000 or \$0.03 per share, basic, and \$0.03 per share, diluted, for the year ended June 30, 2008 compared to net income of \$506,000 or \$0.05 per share, basic, and \$0.05 per share, diluted, for the year ended June 30, 2007.

Liquidity and Capital Resources

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

| | As of | |
|---|---------------|---------------|
| | June 30, 2008 | June 30, 2007 |
| Cash and cash equivalents | \$ 517,000 | \$ 403,000 |
| Working Capital ¹ | \$ 4,586,000 | \$ 6,648,000 |
| Credit Line outstanding balance | \$ 2,000,000 | \$ 300,000 |
| Tangible book value/common share ² | \$ 0.93 | \$ 0.88 |
| Number of days of sales outstanding (DSO) in accounts receivable at end of quarter ³ | 48 | 61 |
| | Year ended | |
| | June 30, 2008 | June 30, 2007 |
| Net cash provided by operations | \$ 2,018,000 | \$ 1,480,000 |

¹ Working Capital = Ending Current Assets balance - Ending Current liabilities balance

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

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

Our working capital at June 30, 2008 decreased to approximately \$4.6 million compared to approximately \$6.6 million at June 30, 2007 as cash flow from operations was used to fund the facilities move and major machinery & equipment purchases. Cash flow provided by operations was \$2,018,000 for the year ended June 30, 2008 compared to \$1,480,000 for the year ended June 30, 2007. Cash was provided through continued profitability and an increase in accounts payable and accrued expense, offset by increases in inventory. In the year ended June 30, 2008, we had a high level of non-cash charges associated with stock based compensation and increased reserves for warranty that amounted to \$574,000 in addition to \$538,000 in depreciation and amortization. Management believes that our working capital needs over the next twelve months can be adequately supported by current operations.

On November 1, 2007, our existing credit facility with Wells Fargo was replaced with an expanded facility with a total borrowing capacity of \$6,562,500. Included in the increase is an increase in the credit line borrowing availability from \$2,000,000 to \$4,000,000. The credit line's terms require monthly interest payments at the prime rate of interest

(5.00% at June 30, 2008); or LIBOR (2.48% at June 30, 2008) plus 1.75%, at our discretion, based on outstanding borrowings. The total effective interest rate at June 30, 2008 for borrowings on the credit line was 4.25%. The credit facility expires on November 1, 2009. In addition to the credit line, a term commitment is available for borrowings for amounts up to \$2,000,000. We can take advances against this commitment through November 1, 2008, at which time the outstanding borrowings against this commitment will be converted to a term loan, to be amortized and repaid over 60 months. The term commitment requires monthly interest payments at the prime rate of interest; or LIBOR plus 2.0%, at our discretion, based on outstanding borrowings. It is anticipated that the borrowings from the term commitment will be used for construction financing of tenant improvements for our Irvine, California facility.

The term loan that was entered into in January 2006 to finance the Astromec purchase remains in place. As of June 30, 2008, there was a principal balance on this term loan of \$395,833 which is required to be fully paid-off in January 2010, in accordance with its amortization schedule. The term loan requires monthly interest payments at the prime rate of interest; or LIBOR plus 2.5%, at our discretion, based on outstanding borrowings, with no minimum interest charge. The total effective interest rate at June 30, 2008 for borrowings on term loan was 5.00%. All assets of the Company except our Carson City land and building secure the outstanding borrowings from Wells Fargo.

There was \$2,000,000 outstanding under the terms of the credit line and nothing outstanding on the term commitment facility as of June 30, 2008. The total available additional borrowing capacity at June 30, 2008 was \$4,000,000, consisting of \$2,000,000 on the credit line and \$2,000,000 on the Tenant Improvement facility.

In March 2006, we entered into a ten year mortgage with Union Bank of California for \$1,650,000. Its terms require monthly interest payments at a fixed rate of 6.73%. 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 a \$1,590,260 outstanding balance under the terms of this mortgage as of June 30, 2008.

There are certain financial and non-financial covenants that we must meet to be in compliance with the terms of the November 2007 Wells Fargo credit facility and the Union Bank mortgage. At June 30, 2008, we were in compliance with the Union Bank covenant and all but one of the Wells Fargo covenants. In the fourth quarter of 2008, we had a net loss that exceeded the quarterly \$300,000 loss restriction covenant in the Wells Fargo credit facility. This covenant was waived by Wells Fargo at no charge. Current forecasts indicate that a quarterly covenant may not be met at the 9/30/2008 measurement date, therefore we have included \$146,000 of debt related to the term note to short term debt from long term debt. If a covenant violation does in fact occur, we would request a waiver at that time, and do not believe the debt would become immediately due.

At June 30, 2008, we had cash and cash equivalents of \$517,000. We believe that our cash and cash equivalents on hand, together with cash flows from operations, if any, and amounts available under the credit facilities will be sufficient to meet our working capital and capital expenditure requirements for this and the next year.

In September 2002, our Board of Directors authorized the repurchase on the open market of up to 500,000 shares of our outstanding Common Stock at a share price no greater than \$1.25, subject to compliance with applicable laws and regulations. There is no requirement that we repurchase all or any portion of such shares. The maximum total value of the repurchase is not to exceed \$500,000. This repurchase is to be financed with cash generated by operations. From the inception of the repurchase authorization through the fiscal year-end date of June 30, 2003, we repurchased 75,700 shares of Common Stock for \$43,741, at an average price of \$0.58 per share. No additional shares were repurchased in fiscal years 2004 through 2008.

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.

Impact of Inflation and Changing Prices

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

Recent Accounting Pronouncements

In June 2006, the FASB issued FIN No. 48, *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109*, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. The interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 requires recognition of tax benefits that satisfy a greater than 50% probability threshold. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN No. 48 is effective for us beginning July 1, 2007.

In September 2006, the FASB issued FAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for fair value measurements, and expands disclosures about fair value measurements. Where applicable, this Statement simplifies and codifies related guidance within generally accepted accounting principles (GAAP). The statement defines that the fair value is the orderly exchange market-based price received to transfer an asset (exit price). It defines the fair value to be determined by quoted prices (level 1), observable inputs (level 2) and unobservable inputs (level 3), in declining order of significance. FAS No. 157 is effective for us beginning July 1, 2008. This FAS was updated in September 2006 to delay application for certain nonfinancial assets and liabilities until July 1, 2009. We do not expect FAS 157 to have a material financial impact on us, but it will require significant additional disclosure in the valuation of our intangible assets.

Item 7. Financial Statements

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

| | |
|--|----|
| <u>Report of Independent Registered Public Company Accounting Firm</u> | 27 |
| <u>Consolidated Balance Sheet</u> | 28 |
| <u>Consolidated Statements of Operations</u> | 29 |
| <u>Consolidated Statements of Shareholders' Equity</u> | 30 |
| <u>Consolidated Statements of Cash Flows</u> | 31 |
| <u>Notes to Consolidated Financial Statements</u> | 32 |

Item 8. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

None.

Item 8A(T). Controls and Procedures.

The Chief Executive Officer and Chief Financial Officer (the principal executive officer and principal financial officer, respectively) conducted an evaluation of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (Exchange Act)). Based on that evaluation for the quarter ended June 30, 2008, the Chief Executive Officer and the Chief Financial Officer concluded that the disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in the reports filed or submitted by the Company under the Exchange Act is accumulated, recorded, processed, summarized and reported to its management, including its principal executive officer and its principal financial officer, as appropriate to allow timely decisions regarding whether or not disclosure is required.

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act). Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework set forth in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, our management concluded that our internal control over financial reporting was effective as of June 30, 2008.

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

- (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets;
- (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of our company are being made only in accordance with authorizations of our management and directors; and
- (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

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

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

During the quarter ended June 30, 2008, there were no changes in the Company's internal controls over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act) that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

PART III

Item 8B. Other Information.

None.

Item 9. Directors, Executive Officers, Promoters, Control Persons and Corporate Governance; Compliance With Section 16(a) of the Exchange Act

Information concerning the Company's Directors and Executive Officers is incorporated by reference from the information contained in the Company's definitive Proxy Statement for the Company's 2008 Annual Meeting of Shareholders to be filed with the SEC within 120 days after the end of the fiscal year ended June 30, 2008 (the "Proxy Statement").

Item 10. Executive Compensation

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

Item 11. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

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

Item 12. Certain Relationships and Related Transactions, and Director Independence

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

Item 13. Exhibits

(1) See Exhibit Index.

Item 14. Principal Accountant Fees and Services

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

Report of Independent Registered Public Accounting Firm

To the Stockholders and Board of Directors of Pro-Dex, Inc.:

We have audited the accompanying consolidated balance sheets of Pro-Dex, Inc. and Subsidiaries (the Company) as of June 30, 2008 and 2007 and the related consolidated statements of operations, shareholders' equity and cash flows for each of the years in the two-year period ended June 30, 2008. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Pro-Dex, Inc. and Subsidiaries as of June 30, 2008 and 2007, and the results of their operations and their cash flows for each of the two years in the two-year period ended June 30, 2008 in conformity with accounting principles generally accepted in the United States of America.

/s/ Moss Adams LLP

Moss Adams LLP

Irvine, California

September 18, 2008

PRO-DEX, INC. and SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

| | <i>30-Jun-08</i> | <i>30-Jun-07</i> |
|---|------------------|------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 517,000 | \$ 403,000 |
| Accounts receivable, net of allowance for doubtful accounts of \$144,000 at June 30, 2008 and \$153,000 at June 30, 2007 | 2,842,000 | 3,436,000 |
| Other Current Receivables | 205,000 | - |
| Inventories, net | 5,101,000 | 4,622,000 |
| Prepaid expenses | 214,000 | 205,000 |
| Prepaid income taxes | | 860,000 |
| Deferred income taxes | 1,176,000 | 1,091,000 |
| Total current assets | 10,915,000 | 9,757,000 |
| Property, plant, equipment and leasehold improvements, net | 6,470,000 | 3,778,000 |
| Other assets: | | |
| Goodwill | 2,997,000 | 2,997,000 |
| Intangibles - Patents, net | 1,221,000 | 1,321,000 |
| Deferred income taxes | - | 229,000 |
| Other | 68,000 | 25,000 |
| Total other assets | 4,286,000 | 4,572,000 |
| Total assets | \$ 21,671,000 | \$ 18,107,000 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Line of credit | \$ 2,000,000 | \$ 300,000 |
| Accounts payable | 1,736,000 | 1,110,000 |
| Accrued expenses | 2,053,000 | 1,183,000 |
| Income taxes payable | 114,000 | 158,000 |
| Current portion of term note | 396,000 | 250,000 |
| Current portion of real estate loan | 30,000 | 26,000 |
| Current portion of patent deferred payable | - | 82,000 |
| Total current liabilities | 6,329,000 | 3,109,000 |
| Long-term liabilities: | | |
| Term note | - | 396,000 |
| Real estate loan | 1,560,000 | 1,593,000 |
| Patent deferred payable | 44,000 | 158,000 |
| Deferred income taxes | 290,000 | |
| Deferred rent | 150,000 | - |
| Total long-term liabilities | 1,754,000 | 2,147,000 |
| Total liabilities | 8,259,000 | 5,256,000 |

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Commitments and contingencies

Shareholders' equity:

Common shares; no par value; 50,000,000 shares authorized;

9,803,366 shares issued and outstanding June 30, 2008

9,718,366 shares issued and outstanding June 30, 2007

| | |
|--|-----------------------------|
| 16,545,000 | 16,340,000 |
| (3,247,000) | (3,489,000) |
| Accumulated deficit | |
| Total shareholders' equity | 13,298,000 12,851,000 |
| Total liabilities and shareholders' equity | \$ 21,671,000 \$ 18,107,000 |

See notes to consolidated financial statements.

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

| | 2008 | 2007 |
|--|---------------|---------------|
| Net sales | \$ 25,126,000 | \$ 21,563,000 |
| Cost of sales | 16,917,000 | 14,196,000 |
| Gross profit | 8,209,000 | 7,367,000 |
| Operating expenses: | | |
| Selling | 1,482,000 | 1,353,000 |
| General and administrative expenses | 3,265,000 | 2,698,000 |
| Irvine facility move related general and administrative expenses | 274,000 | - |
| Research and development costs | 2,732,000 | 2,474,000 |
| Total operating expenses | 7,753,000 | 6,525,000 |
| Income from operations | 456,000 | 842,000 |
| Other: | | |
| Other (expense), net | (9,000) | (4,000) |
| Royalty income | 35,000 | 38,000 |
| Interest income | 17,000 | 18,000 |
| Interest (expense) | (181,000) | (319,000) |
| Total | (138,000) | (267,000) |
| Income before provision for income taxes | 318,000 | 575,000 |
| Provision for Income taxes | (1,000) | (69,000) |
| Net income | \$ 317,000 | \$ 506,000 |
| Net Income per share: | | |
| Basic | \$ 0.03 | \$ 0.05 |
| Diluted | \$ 0.03 | \$ 0.05 |
| Weighted average shares outstanding - basic | 9,736,249 | 9,579,055 |
| Weighted average shares outstanding - diluted | 9,924,350 | 9,739,041 |

See notes to consolidated financial statements.

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

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

See notes to consolidated financial statements.

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

| | 2008 | 2007 |
|--|-------------|------------|
| Cash Flows from Operating Activities: | | |
| Net Income | \$ 317,000 | \$ 506,000 |
| Adjustments to reconcile net income to net cash used in operating activities: | | |
| Depreciation and amortization | 538,000 | 487,000 |
| Loss on disposal | - | 4,000 |
| (Recovery of) Provision for doubtful accounts | (9,000) | 113,000 |
| Reserve for obsolete inventory | (18,000) | 198,000 |
| Stock based compensation | 204,000 | 242,000 |
| Retained earnings adjustment for prior years due to accounting standard change | (75,000) | - |
| Deferred taxes | (434,000) | (177,000) |
| Changes in: | | |
| Decrease in accounts receivable | 397,000 | 292,000 |
| (Increase) in inventories | (460,000) | (840,000) |
| (Increase) in prepaid expenses | (9,000) | (114,000) |
| Decrease in other assets | (43,000) | 19,000 |
| Increase in accounts payable and accrued expenses | 1,645,000 | 371,000 |
| Increase (Decrease) in income taxes payable | (903,000) | 379,000 |
| Net Cash provided by Operating Activities | 2,018,000 | 1,480,000 |
| Cash Flows From Investing Activities: | | |
| Acquisition of Astromec, net of cash acquired | - | (66,000) |
| Purchase of equipment and leasehold improvements | (3,130,000) | (447,000) |
| Purchase of Intangible Assets - Patents related to Intraflow | - | (2,000) |
| Net Cash used in Investing Activities | (3,130,000) | (515,000) |
| Cash Flows from Financing Activities: | | |
| Principal payments of patent deferred payable | (196,000) | (76,000) |
| Net (Payments) Borrowing on Line of Credit | 1,700,000 | (600,000) |
| Principal payments on Term Note | (250,000) | (250,000) |
| Principal payments on Real Estate Loan | (28,000) | (27,000) |
| Proceeds from option and warrant exercise | - | 33,000 |
| Net Cash provided by (used in) Financing Activities | 1,226,000 | (920,000) |
| Net (decrease) increase in Cash and Cash Equivalents | 114,000 | 45,000 |
| Cash and Cash Equivalents, beginning of year | 403,000 | 358,000 |
| Cash and Cash Equivalents, end of year | \$ 517,000 | \$ 403,000 |
| <i>Supplemental Information</i> | | |
| Cash paid for interest | \$ 181,000 | \$ 229,000 |
| Cash paid for income taxes | \$ 560,000 | \$ - |

See notes to consolidated financial statements.

PRO-DEX, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2008 and 2007

NOTE 1 DESCRIPTION OF BUSINESS

Pro-Dex, Inc. specializes in bringing speed to market in the development and manufacture of technology-based solutions that incorporate 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.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

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

Basis of Presentation

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

Revenue Recognition

Revenue on product sales is recognized upon shipment to the customer based on its terms of FOB shipping point, where the risk of loss and title transfer to the customer. We record sales in accordance with SEC Staff Accounting Bulletin No. 104, *Revenue Recognition*. Under these guidelines, revenue is recognized when all of the following exist: persuasive evidence that a sale arrangement exists, delivery of the product has occurred, the price is fixed or determinable, and payment is reasonably assured. We sell some of our products with a warranty that provides for repairs or replacement of any defective parts for a period after the sale. At the time of the sale, the Company accrues an estimate of the cost of providing the warranty based on prior experience. The Company recognizes revenue under research and development agreements as certain deliverables are met as specified in each development contract.

Cash and Cash Equivalents

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

Accounts Receivable

Trade receivables are carried at original invoice amount less an estimate made for doubtful accounts based on a review of all outstanding amounts on a monthly basis. Management determines the allowance for doubtful accounts by identifying troubled accounts and using historical experience applied to an aging of accounts. Trade receivables are written off when deemed uncollectible. Recoveries of trade receivables previously written off are offset against the allowance when received. Changes in reserve for allowance for doubtful accounts are as follows for the years ended June 30, 2008 and 2007:

| | 2008 | 2007 |
|--|------------|------------|
| Balance at the beginning of the year | \$ 153,000 | \$ 40,000 |
| Increase (Decrease) in doubtful accounts | (9,000) | 114,000 |
| Recoveries of bad debt | - | (1,000) |
| Balance at the end of the year | \$ 144,000 | \$ 153,000 |

Inventories

Inventories are stated at the lower of cost (the first-in, first-out method) or market and consist of the following at June 30, 2008 and 2007:

| | 2008 | 2007 |
|--|--------------|--------------|
| Raw Materials | \$ 2,340,000 | \$ 2,474,000 |
| Work in process | 992,000 | 594,000 |
| Development costs under contract | 207,000 | 141,000 |
| Finished goods | 2,533,000 | 2,403,000 |
| Total | \$ 6,072,000 | \$ 5,612,000 |
| Reserve for slow moving and obsolete items | (971,000) | (990,000) |
| Total inventories, net | \$ 5,101,000 | \$ 4,622,000 |

Changes in reserve for slow moving and obsolete inventory for the years ended June 30, 2008 and 2007 were as follows:

| | 2008 | 2007 |
|--------------------------------------|------------|------------|
| Balance at the beginning of the year | \$ 990,000 | \$ 792,000 |
| Increased reserve | 531,000 | 261,000 |
| Inventory disposed | (550,000) | (63,000) |
| Balance at the end of the year | \$ 971,000 | \$ 990,000 |

Inventory disposed was primarily component parts that were associated with older development and production contracts that we determined had little to no chance of being used again due to the availability of newer versions of the components or there was little chance of the product being sold again.

Warranties

The warranty accrual is based on historical costs of warranty repairs and expected future identifiable warranty expenses. Warranty expenses are reflected in the financial statements in Cost of Sales (COS). The warranty accrual and expenses for the years ended June 30, 2008 and 2007 are presented below:

| | Year Ended June 30, | |
|----------------------------|---------------------|--------------|
| | 2008 | 2007 |
| Beginning Balance | \$ 469,000 | \$ 309,000 |
| Cash cost reducing accrual | \$ (906,000) | \$ (819,000) |
| Increased reserve expensed | \$ 1,298,000 | \$ 979,000 |
| Ending Balance | \$ 861,000 | \$ 469,000 |

Property, Plant & Equipment

Property, plant and equipment is recorded at cost and consist of the following as of June 30, 2008 and 2007:

| | 2008 | 2007 |
|--|---------------|--------------|
| Land | \$ 757,000 | \$ 757,000 |
| Building | 1,470,000 | 1,470,000 |
| Leasehold Improvements | 2,259,000 | 490,000 |
| Equipment | 6,416,000 | 4,597,000 |
| Total | \$ 10,902,000 | \$ 7,314,000 |
| Accumulated Depreciation | (4,432,000) | (3,536,000) |
| Total property, plant & equipment, net | \$ 6,470,000 | \$ 3,778,000 |

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

Goodwill and Intangible Assets

The Company accounts for Goodwill and 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 instead tested for impairment at least annually.

We performed impairment tests and recorded no impairment charges in fiscal years ended June 30, 2008 or 2007. We prepare our annual impairment testing on April 1 of each year and did additional testing as of June 30, 2008. We have compared the estimated carrying value with the estimated fair value of the reporting unit and determined that the goodwill was not impaired. Additionally, during the quarter ended June 30, 2008, management determined that there were no events or circumstances which have occurred, that would indicate an impairment of the goodwill had occurred.

| | 2008 | 2007 |
|---------------------------------------|--------------|--------------|
| Goodwill Associated With Micro Motors | \$ 1,110,000 | \$ 1,110,000 |
| Goodwill Associated With Astromec | 1,887,000 | 1,887,000 |
| Total goodwill | \$ 2,997,000 | \$ 2,997,000 |

Intangible assets include the patents associated Oregon Micro Systems purchase in 1995 and with the October, 2005 Intravantage asset purchase. The Oregon Micro Systems patents were fully amortized as of 2001. The Intravantage asset purchase patents are amortized over a 15 year life. Total amortization expense in 2008 and 2007 was \$99,000 and \$99,000, respectively. Intangible assets consist of the following as of June 30, 2008 and 2007:

| | 2008 | 2007 |
|----------------------------|--------------|--------------|
| Intangible assets- Patents | \$ 4,178,000 | \$ 4,178,000 |
| Accumulated amortization | (2,956,000) | (2,857,000) |
| Total Intangible Assets | \$ 1,222,000 | \$ 1,321,000 |

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

| | |
|-------|-----------|
| 2009 | \$99,000 |
| 2010 | 99,000 |
| 2011 | 99,000 |
| 2012 | 99,000 |
| 2013 | 99,000 |
| Total | \$495,000 |

Stock Repurchase Plan

In September 2002, our Board of Directors authorized the repurchase on the open market of up to 500,000 shares of our outstanding Common Stock at a share price no greater than \$1.25, subject to compliance with applicable laws and regulations. There is no requirement that we repurchase all or any portion of such shares. The maximum total value of the repurchase is not to exceed \$500,000. This repurchase is to be financed with cash generated by operations. From the inception of the repurchase authorization through the fiscal year-end date of June 30, 2003, we repurchased 75,700 shares of Common Stock for \$43,741, at an average price of \$0.58 per share. No additional shares were repurchased in fiscal years 2004 through 2008.

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.

Income Taxes

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

Shipping and Handling

The Company includes payments from its customers for shipping and handling in its net revenues line item in accordance with Emerging Issues Task Force (EITF) 00-1-, *Accounting for Shipping and Handling Fees and Costs*. Shipping expenses, which consist primarily of payments made to freight companies, are reported in cost of goods sold.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to credit risk consist principally of cash and trade receivables. The Company places its cash with major financial institutions. At June 30, 2008 and 2007 and at various times throughout 2008 and 2007 the Company had deposits in excess of federally insured limits. Credit sales are made to resellers located throughout the United States and Europe, and account for a substantial portion of trade receivables. We determine collateral is not required for such receivables by monitoring the customers financial position and payment history.

Stock Options and Warrants

We are subject to the revised requirements of the Statement of Financial Accounting Standards (SFAS) No. 123 (R) *Accounting for Stock-Based Compensation* as revised December 2004. This standard establishes the accounting standards for equity compensation, and applies to us in the recognition of the cost of stock options awarded based on the grant-date fair value of those awards. As a small business issuer, the statement was effective for us at the beginning of the first fiscal year that began after December 15, 2005, which was our fiscal year ended June 30, 2007.

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

The fair value and associated compensation cost of each grant is estimated at the grant date using the Black-Scholes option-pricing model with the following weighted-average assumptions: no dividend rate for all years; price volatility of 49% to 57% in 2008, of 58% to 63% in 2007; risk-free interest rates of approximately 3.3% to 4.9% in 2008 and 4.4% to 5.1% in 2007; and expected lives of five to eight years.

Use of Estimates

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

The Company's operations are affected by numerous factors including market acceptance, changes in technologies and new laws and government regulations and policies. The Company cannot predict what impact, if any, the occurrence of these or other events might have on the Company's operations. Significant estimates and assumptions made by management include, but are not limited to: revenue recognition, the allowance for doubtful accounts, the warranty reserve, the reserve for slow moving or obsolete inventories, the carrying value of long-lived and intangible assets impairment of goodwill, and the recovery of deferred income tax assets.

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

Earnings per Share

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

Fair Value of Financial Instruments

The method and assumptions used to estimate the fair value of notes payable, if any, which approximates the carrying value, is based on interest rates for instruments with similar terms and remaining maturities.

Research and Development

Company-funded research and development supports the development of generic rotary drive, motion control and electric motor technology platforms. We seek customer-funded projects to customize 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 research and development costs not associated with contracts or purchase orders are expensed as incurred.

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 year ended June 30, 2008, \$119,000 was recognized as cost of sales, compared to \$124,000 recognized as cost of sales in the year ended June 30, 2007, reflecting the completion of various development contracts during the year.

NOTE 3 - BANK DEBT

On November 1, 2007, our existing credit facility with Wells Fargo was replaced with an expanded facility with a total borrowing capacity of \$6,562,500. Included in the increase is an increase in the credit line borrowing availability from \$2,000,000 to \$4,000,000. The credit line's terms require monthly interest payments at the prime rate of interest (5.00% at June 30, 2008); or LIBOR (2.48% at June 30, 2008) plus 1.75%, at our discretion, based on outstanding borrowings. The total effective interest rate at June 30, 2008 for borrowings on the credit line was 4.25%. The credit facility expires on November 1, 2009. In addition to the credit line, a term commitment is available for borrowings for amounts up to \$2,000,000. We can take advances against this commitment through November 1, 2008, at which time the outstanding borrowings against this commitment will be converted to a term loan, to be amortized and repaid over 60 months. The term commitment requires monthly interest payments at the prime rate of interest; or LIBOR plus 2.0%, at our discretion, based on outstanding borrowings. The borrowings from the term commitment will be used for construction financing of tenant improvements for our Irvine, California facility.

The term loan that was entered into in January 2006 to finance the Astromec purchase remains in place. As of June 30, 2008, there was a principal balance on this term loan of \$395,833 which is required to be fully paid-off in January 2010, in accordance with its amortization schedule. The term loan requires monthly interest payments at the prime rate of interest; or LIBOR plus 2.5%, at our discretion, based on outstanding borrowings, with no minimum interest charge. The total effective interest rate at June 30, 2008 for borrowings on term loan was 5.00%. All assets of the Company except our Carson City land and building secure the outstanding borrowings from Wells Fargo.

There was \$2,000,000 outstanding under the terms of the credit line and nothing outstanding against term commitment facility as of June 30, 2008. The total eligible additional borrowing capacity at June 30, 2008 was \$4,000,000, consisting of \$2,000,000 on the credit line and \$2,000,000 on the Tenant Improvement facility.

In March 2006, we entered into a ten year mortgage with Union Bank of California for \$1,650,000. Its terms require monthly interest payments at a fixed rate of 6.73%. 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 a \$1,590,260 outstanding balance under the terms of this mortgage as of June 30, 2008.

There are certain financial and non-financial covenants that we must meet to be in compliance with the terms of the November 2007 Wells Fargo credit facility, and the Union Bank mortgage. At June 30, 2008, we were in compliance with the Union Bank covenant and all but one of the Wells Fargo covenants. In the fourth quarter of 2008, we had a net loss that exceeded the quarterly \$300,000 loss restriction covenant in the Wells Fargo credit facility. This covenant was waived by Wells Fargo at no charge. Current forecasts indicate that a quarterly covenant may not be met at the 9/30/2008 measurement date, therefore we have included \$146,000 of debt related to the term note to short term debt from long term debt. If a covenant violation does in fact occur, we would request a waiver at that time, and do not believe the debt would become immediately due.

NOTE 4 - COMMITMENTS AND CONTINGENCIES

The Company leases its existing office and warehouse facilities in Irvine, California and Beaverton, Oregon. The Irvine lease expires in March 2018 and the Beaverton lease expires in April 2014. These leases require the Company to pay insurance, taxes, and other expenses related to the leased space. Total rent expense in 2008 and 2007 was \$625,000 and \$310,000, respectively. Future minimum lease payments for the fiscal year ending June 30 are:

| | |
|-----------|-------------|
| 2009 | \$450,015 |
| 2010 | \$469,137 |
| 2011 | \$488,325 |
| 2012 | \$507,585 |
| 2013 | \$526,917 |
| 2014-2018 | \$2,408,635 |
| Total | \$4,850,614 |

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.

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. Management is not aware of any other material actual, pending or threatened litigation at this time.

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NOTE 5 - Income Taxes

The provisions for income taxes for the years ended June 30, 2008 and 2007 are as follows:

| | Fiscal Year ended June 30, | |
|----------------------------|----------------------------|------------|
| | 2008 | 2007 |
| Current: | | |
| Federal | \$ (403,000) | \$ 201,000 |
| State | (29,000) | 45,000 |
| Deferred: | | |
| Federal | 425,000 | (111,000) |
| State | 8,000 | (66,000) |
| Provision for Income taxes | \$ 1,000 | \$ 69,000 |

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

| | Fiscal Year ended June 30, | |
|--|----------------------------|------------|
| | 2008 | 2007 |
| Federal income tax at the statutory rate | \$ 108,000 | \$ 195,000 |
| State Income taxes, net of federal tax benefit | 39,000 | 58,000 |
| Tax Incentives | (122,000) | (195,000) |
| Tax effect of non-deductible items | 51,000 | (5,000) |
| FIN 48 Liability | (84,000) | |
| Other | 9,000 | 16,000 |
| Provision for Income taxes | \$ 1,000 | \$ 69,000 |

Deferred income tax assets and liabilities in the accompanying consolidated balance sheet at June 30, 2008 and 2007 are as follows:

Fiscal Year ended June 30,

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| Current Deferred income tax assets | 2008 | 2007 |
|------------------------------------|--------------|--------------|
| Deferred tax assets | | |
| Accrued expenses | \$ 535,000 | \$ 389,000 |
| Inventories | 660,000 | 535,000 |
| Net Operating Losses | | 73,000 |
| Income tax credit carry forwards | - | 202,000 |
| Total deferred tax assets | 1,268,000 | 1,126,000 |
| Deferred tax liabilities | | |
| State taxes | \$ (92,000) | \$ (35,000) |
| Total deferred tax liabilities | (92,000) | (35,000) |
| Net Current Deferred tax assets | \$ 1,176,000 | \$ 1,091,000 |

| Long Term Deferred income tax assets/(liabilities) | Fiscal Year ended June 30, | |
|--|----------------------------|-------------|
| | 2008 | 2007 |
| Deferred tax assets | | |
| Intangible assets | \$ 268,000 | \$ 450,000 |
| Non cash stock based compensation | 113,000 | 65,000 |
| Income tax credit carry forwards | 351,000 | - |
| Total deferred tax assets | 732,000 | 515,000 |
| Deferred tax liabilities | | |
| State taxes | \$ (57,000) | \$ (97,000) |
| Depreciation | (965,000) | (189,000) |
| Total deferred tax liabilities | (1,022,000) | (286,000) |
| Net Deferred tax assets/(liabilities) | \$ (290,000) | \$ 229,000 |

We have state net operating loss carry forwards for June 30, 2008 and 2007 of \$1,002,000 and \$0, respectively. We have federal tax credits of \$103,000 and \$0 for June 30, 2008 and 2007, respectively, and state tax credits of \$248,000 and \$202,000 for June 30, 2008 and 2007, respectively.

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, (FIN 48), an interpretation of FASB Statement No. 109, Accounting for Income Taxes, (FASB 109). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB 109. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The cumulative effect of applying FIN 48 is to be reported as an adjustment to the opening balance of retained earnings in the year of adoption. As a result of the implementation of FIN 48, the Company recorded a decrease of \$75,000 to retained earnings, an increase of \$47,000 to net deferred income tax assets and an increase of \$122,000 to income taxes payable as of July 1, 2007.

As of June 30, 2008, the Company has provided a liability for \$114,000 of unrecognized tax benefits related to various federal and state income tax matters. Of this total, \$62,000 relates to R&D credits and would reduce the Company's income tax expense if recognized and would result in a corresponding decrease in the Company's effective tax rate.

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

| | Year Ended June 30, 2008 | |
|---|-----------------------------|----------|
| Beginning Balance | \$ | 212,000 |
| Additions based on tax provisions related to the current year | \$ | - |
| Additions for tax positions in prior years | \$ | - |
| Reductions for tax provisions of prior years | \$ | (98,000) |
| Settlements | \$ | - |
| Ending Balance | \$ | 114,000 |

We recognize accrued interest and penalties related to unrecognized tax benefits in income tax expense. As of June 30, 2008, we had approximately \$52,000 in accrued interest and penalties which is included as a component of the \$114,000 unrecognized tax benefit noted above. The liability for the payment of interest and penalties has increased by approximately \$0 for the twelve months ended June 30, 2008.

We are undergoing an examination by the Internal Revenue Service (IRS) of its Federal income tax returns filed for the fiscal years ending June 30, 2004, June 30, 2005 and June 30, 2006. Findings of the examination indicate that there may have been differences in the timing of our tax payments due to the treatment of inventory uniform capitalization rules. As a result of the examination, we paid approximately \$179,000 of additional tax payments in May 2008. Subsequent to year end, we received a final interest invoice and paid \$31,000 of interest to the IRS. The interest amounts have been accrued and are included in accrued expenses and interest as of June 30, 2008. Although we have not received a final audit closing notification, we believe it will conclude in the next 12 months and do not believe there will be any material adjustments resulting from the examination beyond those described above. We believe the appropriate provisions for all outstanding issues have been made for all years under audit.

We are subject to income tax of multiple state tax jurisdictions. Our state income tax returns are open to audit under the statute of limitations for the years ended June 30, 2003 through June 30, 2007. We do not anticipate a significant change to the total amount of unrecognized tax benefits within the next 12 months.

NOTE 6 - SHAREHOLDERS' EQUITY**Stock Options**

The Board of Directors and the shareholders of the Company have approved and adopted two equity compensation plans, pursuant to which i) options to purchase, or ii) restricted shares, may be granted in an aggregate of 2,500,000 shares of common stock that may be granted to officers, directors, and employees of the Company. Upon its adoption, the employee stock option plan had 2,000,000 options to purchase shares or restricted shares issuable and the directors plan had 500,000 options to purchase shares. There are options to purchase 346,045 shares remaining under the employee option plan, and options to purchase 130,000 shares remaining under the directors option plan for a total of 476,045 shares remaining under both option plans at June 30, 2008 that are available to grant in future years.

The aggregate amount of shares available to employees under the employee stock option plan was increased by 500,000 to the current level of shares available at the 2006 annual shareholders meeting. New shares are created as such options are exercised or restricted shares are granted. Share-based compensation expense reduced the Company's results of operations as shown:

| | Fiscal Year ended June 30, | |
|--|----------------------------|------------|
| | 2008 | 2007 |
| Share-based compensation expense recognized: | | |
| General and administrative, options | 87,000 | 86,000 |
| General and administrative, restricted stock | 117,000 | 156,000 |
| Related deferred tax benefit | (47,000) | (62,000) |
| Decrease in net income | \$ 157,000 | \$ 180,000 |
| Decrease in basic earnings per share | \$ 0.02 | \$ 0.02 |
| Decrease in diluted earnings per share | \$ 0.02 | \$ 0.02 |

As of June 30, 2008, there was \$101,104 of total unrecognized compensation cost related to 123,000 non vested outstanding stock options with a per share weighted average value of \$0.82. The unrecognized expense is anticipated to be recognized on a straight-line basis over a weighted average period of 1.3 years.

The following is a summary of stock option activity:

| | 2008 | | 2007 | |
|--|-----------|---------------------------------|-----------|---------------------------------|
| | Shares | Weighted-Average Exercise Price | Shares | Weighted-Average Exercise Price |
| Fixed Options Outstanding at beginning of year | 1,038,500 | \$ 1.60 | 1,204,316 | \$ 1.68 |

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| | | | | | |
|--|-----------|---------|--|-----------|---------|
| Granted | 101,000 | 1.50 | | 166,000 | 1.49 |
| Exercised | - | - | | (106,816) | 0.45 |
| Forfeited | (30,000) | 1.86 | | (225,000) | 2.52 |
| Outstanding at end of year | 1,109,500 | \$ 1.58 | | 1,038,500 | \$ 1.60 |
| Exercisable at end of year | 986,500 | \$ 1.58 | | 881,250 | \$ 1.56 |
| Weighted-average fair value per Option granted during the year | | \$ 0.79 | | | \$ 0.94 |

The following table summarizes information regarding options outstanding and options exercisable at June 30, 2008:

| Range of Exercise Price | Number Outstanding | Options Outstanding | | | Options Exercisable | | |
|-------------------------|--------------------|---|---------------------------------|---------------------------|---------------------------------|---------------------------|------------|
| | | Weighted-Average Remaining Contractual Life | Weighted-Average Exercise Price | Aggregate Intrinsic Value | Weighted-Average Exercise Price | Aggregate Intrinsic Value | |
| \$0.42 to \$0.81 | 260,000 | 3.7 years | \$ 0.70 | \$ 216,200 | 260,000 | \$ 0.70 | \$ 216,200 |
| \$1.08 to \$1.56 | 432,000 | 6.4 years | 1.37 | \$ 68,220 | 327,750 | 1.34 | \$ 61,958 |
| \$1.74 to \$2.18 | 242,500 | 3.7 years | 2.04 | \$ - | 236,250 | 1.99 | \$ - |
| \$2.44 to \$3.30 | 175,000 | 7.0 years | 2.77 | \$ - | 162,500 | 2.79 | \$ - |
| Total | 1,109,500 | 5.3 years | \$ 1.58 | \$ 284,420 | 986,500 | \$ 1.58 | \$ 278,158 |

The option plans are substantially similar, call for vesting as approved by the Board of Directors of six months for directors and up to five years for employees, and allow for the options to be outstanding for a period of up to ten years but are forfeited 30 days after the holder ceases to be an employee or director.

Restricted Stock

In connection with the employment agreement with our Chief Executive Officer, a restricted stock grant of 340,000 shares of common stock was made in February 2007. These shares vest in four equal installments of 25% or 85,000 shares per year over 4 years. The common stock price at the date of the grant was \$1.38. New shares are issued with the issuance of each installment of restricted stock. The fair value of the grant is calculated as the number of shares multiplied by the grant price. The compensation expense is recognized over the vesting period of the grant. Approximately \$117,000 in compensation expense for the restricted stock was recognized in fiscal year 2008.

The following is a summary of restricted share activity:

| | 2008 | Weighted- | 2007 | Weighted- |
|----------------------------------|----------|----------------|----------|----------------|
| Restricted shares | Shares | Average | Shares | Average |
| | | Exercise Price | | Exercise Price |
| Outstanding at beginning of year | 255,000 | \$ 1.38 | - | \$ - |
| Granted | - | - | 340,000 | 1.38 |
| Exercised | (85,000) | 1.38 | (85,000) | 1.38 |
| Forfeited | - | - | - | - |
| Outstanding at end of year | 170,000 | \$ 1.38 | 255,000 | \$ 1.38 |
| Exercisable at end of year | - | \$ - | - | \$ - |

As of June 30, 2008, there was \$196,000 of total unrecognized compensation cost related to 141,667 non vested outstanding restricted shares with a per share weighted average value of \$1.38. The unrecognized expense is anticipated to be recognized on a straight-line basis over a weighted average period of 1.7 years.

Stock Warrants

At June 30, 2008, warrants to acquire 100,000 shares of common stock were outstanding. These warrants are fully vested, have a weighted-average exercise price of \$1.25 and a weighted-average remaining life of 1.0 years.

NOTE 7 - NET INCOME PER SHARE

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

| | 2008 | 2007 |
|---|------------|------------|
| Net income | \$ 317,000 | \$ 506,000 |
| Basic net income per common share: | | |
| Weighted average number of common shares outstanding | 9,736,429 | 9,579,055 |
| Basic net income per common share | \$ 0.03 | \$ 0.05 |
| Diluted net income per share: | | |
| Weighted average of common shares outstanding | 9,736,429 | 9,579,055 |
| Effect of potentially dilutive securities (options) | 169,761 | 152,434 |
| Effect of potentially dilutive securities (restricted shares) | 8,160 | - |
| Effect of potentially dilutive securities (warrants) | 10,000 | 7,552 |
| Weighted average number of common and shares - | | |
| Diluted | 9,924,350 | 9,739,041 |
| Diluted net income per common share | \$ 0.03 | \$ 0.05 |

NOTE 8 - MAJOR CUSTOMERS

We had two major customers (defined as a customer that represented greater than 10% of the Company's total revenues) in the year ended June 30, 2008 and 2007.

Year ended June 30,

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| | 2008 | | 2007 | |
|------------|--------------|-------------|--------------|-------------|
| | Revenues | Accts. Rec. | Revenues | Accts. Rec. |
| Customer 1 | \$ 4,429,000 | \$ 408,000 | \$ 5,059,000 | \$ 961,000 |
| Customer 2 | \$ 8,075,000 | \$ 621,000 | \$ 3,643,000 | \$ 128,000 |

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Part III

Item 1. Index to Exhibits

Exhibit No. Document

- 3.1 Articles of Incorporation (incorporated herein by reference to Exhibit 3.1 to the Company's Form 8-K filed April 23, 2007).
- 3.2 Bylaws (incorporated herein by reference to Exhibit 3.2 to the Company's Form 8-K filed April 23, 2007).
- 10.1* 1994 Employees Stock Option Plan, as amended (incorporated herein by reference to Exhibit 10.22 to the Company's Registration Statement on Form S-4 filed April 13, 1994).
- 10.2* 1994 Directors Stock Option Plan as amended (incorporated herein by reference to Exhibit 10.22 to the Company's Registration Statement on Form S-4 filed April 13, 1994).
- 10.3* First Amended and Restated 2004 Stock Option Plan (incorporated herein by reference to Exhibit 4.0 to the Company's Form S-8 filed March 9, 2007).
- 10.4* 2004 Directors Stock Option Plan (incorporated herein by reference to Exhibit 4.2 to the Company's Form S-8 filed January 23, 2004).
- 10.5 Audit Committee Charter (incorporated herein by reference to Exhibit 10.26 to the Company's Form 10-KSB filed October 1, 2002).
- 10.6 Asset Purchase Agreement, dated October 31, 2005 between IntraVantage, Inc. (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed November 2, 2005).
- 10.7 Exclusive License Agreement, dated October 31, 2005, between Pro-Dex, Inc. and IntraVantage, Inc. (incorporated herein by reference to Exhibit 10.2 to the Company's Form 8-K filed November 2, 2005).
- 10.8 Royalty Agreement, dated October 31, 2005, between Pro-Dex, Inc. and IntraVantage, Inc. (incorporated herein by reference to Exhibit 10.3 to the Company's Form 8-K filed November 2, 2005).
- 10.9 Asset Purchase Agreement, dated January 5, 2006 between Pro-Dex, Astromec, Inc., Astromec, Inc., M.D. Glover, Inc., Malcolm D. Glover, Jr., and Malcolm D. Glover, Sr. (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed January 6, 2006).
- 10.10 Purchase and Sale Agreement and Escrow Instructions, dated January 3, 2006, between Pro-Dex, Inc. and M.D. Glover, Inc. (incorporated herein by reference to Exhibit 10.2 to the Company's Form 8-K filed January 6, 2006).
- 10.11 Term Note, dated January 4, 2006, by Pro-Dex, Inc. and Wells Fargo Bank, National Association (incorporated herein by reference to Exhibit 10.3 to the Company's Form 8-K filed January 6, 2006).
- 10.12 Loan Agreement, dated January 4, 2006, between Pro-Dex, Inc. and Wells Fargo Bank, National Association (incorporated herein by reference to Exhibit 10.4 to the Company's Form 8-K filed January 6, 2006).
- 10.13 Promissory Note, dated March 4, 2006, effective March 30, 2006, by Pro-Dex, Inc. in favor of Union Bank of California, National Association (incorporated herein by reference to Exhibit 10.1 to the

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- Company's Form 8-K filed April 3, 2006).
- 10.14 Loan Agreement, dated March 4, 2006, effective March 30, 2006, by Pro-Dex, Inc. in favor of Union Bank of California, National Association (incorporated herein by reference to Exhibit 10.2 to the Company's Form 8-K filed April 3, 2006).
- 10.15* Employment Agreement with Mark Murphy dated August 14, 2006 (incorporated herein by reference to Exhibit 10.44 to the Company's Form 10-KSB filed September 28, 2006).
- 10.16 Lease agreement with Irvine Business Properties, dated August 17, 2007 (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed August 23, 2007).
- 10.17* Letter Agreement with Patrick Johnson dated October 18, 2006 (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed October 24, 2006).
- 21.1^{xx} List of Subsidiaries (incorporated herein by reference to Exhibit 21.1 to the Company's Form 10-KSB filed September 28, 2007).
- 23.1^{xx} Consent Letter of Moss Adams LLP.
- 31.1^{xx} Certification of the Chief Executive Officer Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2^{xx} Certification of the Chief Financial Officer Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32^{xx} Certification of the Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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

^{xx} Filed Herewith

SIGNATURES

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

PRO-DEX INC.

/ s / Mark P. Murphy

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

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

/ s / Mark P. Murphy

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

September 22, 2008

Date

/ s / Jeffrey J. Ritchey

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

September 22, 2008

Date

/ s / George J. Isaac

George J. Isaac

September 22, 2008

Date

Director

/ s / Michael Mesenbrink

September 22, 2008

Michael Mesenbrink
Director

Date

/ s / Valerio Giannini

September 22, 2008

Valerio Gianinni
Director

Date

/ s / William L. Healey

September 22, 2008

William L. Healey
Director

Date

End of Filing