

PRO DEX INC  
Form 10-K  
September 18, 2014

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

FORM 10-K

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.  
For the fiscal year ended June 30, 2014

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF  
1934.

FOR THE TRANSITION PERIOD FROM TO .

Commission File Number 000-14942

PRO-DEX, INC.

(Exact name of registrant as specified in its charter)

Colorado  
(State or other  
jurisdiction of  
incorporation or  
organization)

84-1261240  
(I.R.S. Employer  
Identification No.)

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

**Registrant's telephone number, including area code: (949) 769-3200**

**Securities registered pursuant to Section 12(b) of the Act:**

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

**Securities registered pursuant to Section 12(g) of the Act: None**

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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer  Accelerated filer  Non-accelerated filer (do not check if a smaller reporting company)   
Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

As of December 31, 2013, the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the closing sales price on the Nasdaq Capital Market was approximately \$5.5 million. 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 calculation does not reflect a determination that persons are affiliates for any other purposes.

As of September 2, 2014, 4,211,019 shares of the registrant's no par value common stock were outstanding.

Documents incorporated by reference:

Part III of this report incorporates by reference certain information from the registrant's definitive proxy statement (the "Proxy Statement") for its 2014 Annual Meeting of Shareholders. The Proxy Statement will be filed with the U.S. Securities and Exchange Commission within 120 days after the end of the fiscal year to which this report relates.

**PRO-DEX, INC.**

**FORM 10-K**

**FOR THE FISCAL YEAR ENDED JUNE 30, 2014**

**TABLE OF CONTENTS**

|   | <u>Page</u> |
|---|-------------|
| <u>PART I</u>   | 1           |
| <u>ITEM 1. BUSINESS</u>   | 1           |
| <u>ITEM 1A. RISK FACTORS</u>  | 5           |
| <u>ITEM 1B. UNRESOLVED STAFF COMMENTS</u>   | 11          |
| <u>ITEM 2. PROPERTIES</u>   | 11          |
| <u>ITEM 3. LEGAL PROCEEDINGS</u>  | 11          |
| <u>ITEM 4. MINE SAFETY DISCLOSURES</u>  | 11          |
| <br><u>PART II</u>  | <br>12      |
| <u>ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES</u> | 12          |
| <u>ITEM 6. SELECTED FINANCIAL DATA</u>  | 13          |
| <u>ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u>                        | 13          |
| <u>ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u>  | 21          |
| <u>ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA</u>  | 22          |
| <u>ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE</u>                         | 44          |
| <u>ITEM 9A. CONTROLS AND PROCEDURES</u>   | 44          |
| <u>ITEM 9B. OTHER INFORMATION</u>   | 44          |
| <br><u>PART III</u>   | <br>45      |
| <u>ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE</u>  | 45          |
| <u>ITEM 11. EXECUTIVE COMPENSATION</u>  | 45          |
| <u>ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS</u>              | 45          |
| <u>ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE</u>                                   | 45          |
| <u>ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES</u>  | 45          |
| <br><u>PART IV</u>  | <br>46      |
| <u>ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES</u>   | 46          |

Table of Contents

PART I

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements within the meaning of federal securities laws. Forward-looking statements are not based on historical facts but instead reflect the Company's expectations, estimates or projections concerning future results or events. These statements generally can be identified by the use of forward-looking words or phrases such as "believe," "expect," "anticipate," "may," "could," "intend," "intent," "belief," "estimate," "project," "foreca," "will," "should" or similar words or phrases. These statements are not guarantees of performance and are inherently subject to known and unknown risks, uncertainties and assumptions that are difficult to predict and could cause actual results, performance or achievements to differ materially from those expressed or indicated by those statements. The Company cannot assure you that any of its expectations, estimates or projections will be achieved.

Forward-looking statements included in this report are only made as of the date of this report and the Company disclaims any obligation to publicly update any forward-looking statement to reflect subsequent events or circumstances.

Numerous factors could cause the Company's actual results and events to differ materially from those expressed or implied by forward-looking statements, including, without limitation: loss of a significant customer, entry of new and stronger competitors, capital availability, unexpected costs, compliance with contractual obligations, failure to capitalize upon access to new customers, marketplace delisting, the ramifications of industry consolidation of medical products manufacturers, dealers and distributors, managed health care, market acceptance and support of new products, cancellation of existing contracts, customer "in house" production of products previously designed by and/or acquired from the Company, maintaining favorable supplier relationships, the Company's ability to engage qualified human resources as needed, regulatory compliance, general economic conditions and other factors described under Item 1A (Risk Factors) of this report. This list of factors is illustrative, but by no means exhaustive. All forward-looking statements should be evaluated with the understanding of their inherent uncertainty.

ITEM 1. BUSINESS

Company Overview

Pro-Dex, Inc. ("Company", "Pro-Dex", "we", "our", "us"), with operations in Irvine, California and Beaverton, Oregon, designs and produces powered surgical and dental instruments and motion control products used in the medical, factory automation and scientific research industries.

Our products are found in hospitals, dental offices, medical engineering labs, scientific research facilities and high-tech manufacturing operations around the world. In addition to Pro-Dex, the names Micro Motors and Oregon Micro Systems are used for marketing purposes as brand names.

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

[www.sec.gov/edgar/searchedgar/companysearch.html](http://www.sec.gov/edgar/searchedgar/companysearch.html).

Table of Contents

In February 2012, we sold our fractional horsepower motor product line located in Carson City, Nevada, operating under the name Pro-Dex Astromec (“Astromec”) to a third party. As a result of the sale, this product line has been classified as a discontinued operation in conformity with applicable accounting guidance. Accordingly, unless otherwise indicated, Astromec’s results have been reported as discontinued operations and removed from all financial discussions of continuing operations, including the Consolidated Financial Statements and Notes, beginning on page 23 of this report.

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

## Description of Business

The majority of our revenue is derived from designing, developing and manufacturing powered instruments for the medical and dental industries and motion control software and hardware for industrial and scientific applications. The proportion of total sales by customer type is as follows:

|                           | Years Ended June 30, |         |      |          |         |   |
|---------------------------|----------------------|---------|------|----------|---------|---|
|                           | 2014                 |         | 2013 |          |         |   |
|                           | (In thousands)       |         |      |          |         |   |
|                           |                      | % of    |      |          | % of    |   |
|                           |                      | Revenue |      |          | Revenue |   |
| Medical device            | \$6,848              | 64      | %    | \$7,970  | 65      | % |
| Industrial and scientific | 2,392                | 22      | %    | 2,594    | 21      | % |
| Dental                    | 1,219                | 11      | %    | 1,092    | 9       | % |
| Government and other      | 353                  | 3       | %    | 593      | 5       | % |
| Total Sales               | \$10,812             | 100     | %    | \$12,249 | 100     | % |

Our medical device products utilize proprietary designs developed by us primarily under exclusive development and supply agreements and are manufactured in our Irvine, California facility, as are our dental products. Our medical device products are sold primarily to original equipment manufacturers and our dental products are sold primarily to dental product distributors. In our Beaverton, Oregon facility, we design and manufacture embedded multi-axis motion controllers which are sold to distributors or original equipment manufacturers in the automation and research industries. The proportion of total sales by facility is as follows:

|             | Years Ended June 30, |         |      |          |         |   |
|-------------|----------------------|---------|------|----------|---------|---|
|             | 2014                 |         | 2013 |          |         |   |
|             | (In thousands)       |         |      |          |         |   |
|             |                      | % of    |      |          | % of    |   |
|             |                      | Revenue |      |          | Revenue |   |
| Irvine      | \$9,298              | 86      | %    | \$10,531 | 86      | % |
| Beaverton   | 1,514                | 14      | %    | 1,718    | 14      | % |
| Total Sales | \$10,812             | 100     | %    | \$12,249 | 100     | % |

In fiscal year 2014, our top 20 customers accounted for 82% of our sales, compared to 81% in fiscal year 2013. In fiscal year 2014, our largest customer, included in medical device revenue above, accounted for 49% of our sales with our next largest customer accounting for 6% of our sales. This compares to fiscal year 2013, when our largest customer accounted for 46% of our sales, with our next largest customer accounting for 6% of our sales. In many cases, including our largest customers, disclosure of customer names is prohibited by confidentiality agreements with such entities.

We have no plans to discontinue the sales relationships with our existing significant customers and have no knowledge of them discontinuing their sales relationship with us.

### Table of Contents

We continue to implement the steps of a strategic plan, the objectives of which are to sustain business with our largest customer, successfully complete two significant engineering projects currently in progress and release the related products to manufacturing, identify and capture additional revenue opportunities and continue to effectively manage our reduced operating costs. There can be no assurance, however, as to either the timing or success of achieving these objectives, which, during any period not achieved, may cause a prolonged material and adverse impact on our business.

The majority of the raw materials and components used to manufacture our products are purchased and are available from several sources. Precision Interconnect, Transicoil and Portescap Danaher are examples of key suppliers. We have no exclusive arrangements with any of our suppliers, but in several instances only one supplier is used for certain high-value components. In most of such instances, secondary suppliers have been identified, although it is likely that any transition to a new or different supplier would result in a delay in the supply chain. We consider our relationships with our suppliers and manufacturers to be good. We do not intend to terminate any such relationship at this time, nor does management have knowledge that any supplier or manufacturer intends to terminate its relationship with us.

Our commitment to product design, manufacturing and quality systems are supported by our compliance with several regulatory agency requirements and standards. We hold a U.S. Food and Drug Administration (“FDA”) Establishment Registration and a State of California Device Manufacturing License (Dept of Public Health Food and Drug Branch) with respect to our Irvine, California facility. In addition, our Irvine, California facility is certified to ISO 13485:2003, Medical Device Directive 93/42/EEC – Annex II, and Canadian Medical Device Conformity Assessment System. Our Beaverton, Oregon facility is certified to ISO 9001:2008.

At June 30, 2014, we had a backlog of \$2.8 million compared with a backlog of \$6.7 million at June 30, 2013. We have experienced, and may continue to experience, variability in our new order bookings due to, among other reasons, the timing of customer orders based on end-user demand and customer inventory levels, illustrative of which is our receipt in July 2014 of purchase orders from our largest customer aggregating approximately \$3.5 million for shipments extending through December 2015. We do not typically experience seasonal fluctuations in our shipments and revenues.

### Competition

The markets for products in the industries served by our customers 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 medical device and motion control related companies. As a provider of outsourced services, we also compete with our customers’ own internal development and manufacturing groups. Competitive pressures and other factors, such as new product or new technology introductions by us, our customers’ internal development and manufacturing departments, 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 research and development activities to both maintain and improve our market position. Our research and development effort involves the design and manufacture of products that perform specific applications for our existing and prospective customers. Our research and development activities are focused on:

expanding our knowledge base in the medical device and motion control industries to solidify our products with current customers and expand our customer base;

advancing applicable technologies; and  
enhancing our product lines.

3

### Table of Contents

In certain instances we may share research and development costs with our customers by billing for non-recurring engineering services. Fees received for non-recurring engineering services represented 2% of our revenue in both fiscal years 2014 and 2013. During fiscal years 2012 and 2013, we entered into certain development and supply contracts, the development portions of which are in progress and provide for billable non-recurring engineering service fees. Such fees are recognized as revenue generally upon successful completion of the non-recurring engineering services, which we believe will occur in fiscal year 2015, although successful completion cannot be assured. We also intend to pursue other revenue-generating development projects. Accordingly, we believe that non-recurring engineering fees could represent a greater share of our revenue in the future.

During the fiscal years ended June 30, 2014 and 2013, we incurred research and development expenses amounting to \$1,482,000 and \$1,790,000, respectively, which costs exclude \$511,000 and \$370,000 in 2014 and 2013, respectively, that were, or will be, shared with our customers through billings for non-recurring engineering services.

### **Employees**

At June 30, 2014, we had 62 full-time employees, comprised of 53 employees in Irvine and 9 in Beaverton. At June 30, 2013, we had 67 full-time employees. During each of the three fiscal years in the period ended June 30, 2014, we have initiated reductions-in-force as part of a strategic plan to reduce expenses.

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**

The manufacture and distribution of medical and dental devices are subject to state and federal requirements set forth by various agencies, including the FDA, and state medical and dental boards. 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 the ongoing risk that one or more of our activities or devices may at some point be determined to be 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, the costs to achieve such a determination and the intervening loss of business could adversely affect or result in the cessation of a portion of our business. A change in such laws or regulations at any time may have an adverse effect on our operations.

The FDA designates all medical devices into one of three classes (Class I, II or III) based on the level of control necessary to assure the safety and effectiveness of the device (with Class I requiring the lowest level of control and Class III requiring the greatest level of control). The surgical instrumentation we manufacture is generally classified into Class I, and our dental instrumentation is generally classified into Class II. 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.

The total cost of providing health care services has been and will continue to be subject to review by governmental agencies and legislative bodies in the major world markets, including the United States, which are faced with significant pressure to lower health care costs. The Patient Protection and Affordable Care Act signed into law in

March 2010 (the “Affordable Care Act”) imposes a 2.3% excise tax on sales of certain medical devices, some of which we produce, that we may be unable to recover through price increases to our customers.

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 believe 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 be undertaken in the future with respect to our products or processes.

Management believes that each of our facilities has manufacturing systems and processes that are based on established Quality Management System standards. In addition, we believe that our Irvine, California facility is compliant with applicable Good Manufacturing Practices promulgated by the FDA, and is, along with our Beaverton, Oregon facility, compliant with applicable ISO standards set forth by the International Organization for Standardization.

Table of Contents

**Patents, Trademarks and Licensing Agreements**

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

We have no reason to believe that our activities infringe upon the intellectual property of any third party. With respect to our own patents, we have no reason to believe that our patents are invalid and we believe that at least some of our patents cover certain aspects of our products. While we are unaware of any reason that would cause us to assert or defend a claim of patent infringement, any such assertion or defense could materially and adversely affect our business and results of operations due to the costs involved.

We have certain federally registered trademarks relating to our products, including Pro-Dex® OMS® and OMS-EZ®, along with a number of other common law trademarks.

We have not entered into any franchising agreements. We have not granted nor do we hold any third-party licenses having terms under which we earn revenue or incur expense in material amounts.

**ITEM 1A. RISK FACTORS**

*Investing in our common stock involves a high degree of risk. You should carefully consider the following risk factors, as well as the other information contained in this report, before deciding whether to invest in shares of our common stock. If any of the following risks actually occur, our business, financial condition, operating results and prospects would suffer. In that case, the trading price of our common stock would likely decline and you might lose all or part of your investment in our common stock. The risks described below are not the only ones we face. Additional risks that we currently do not know about or that we currently believe to be immaterial may also impair our operations and business results.*

**A substantial portion of our revenue is derived from a single customer. If we were to lose that customer, it would have a material adverse effect on our business, financial condition and results of operations.**

In fiscal year 2014, our top 20 customers accounted for 82% of our sales, with our largest customer accounting for 49% of our sales. The loss of our largest customer, or the loss of any other significant customer, would severely impact us, including having a material adverse effect on our business, financial condition, cash flows, revenue and results of operations.

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

Over the past several fiscal years our total sales have contracted from \$27.1 million in 2011 to \$17.3 million in 2012, \$12.2 million in 2013 and \$10.8 million in 2014. We continue to implement the steps of a strategic plan, the objectives of which are to identify and capture additional revenue opportunities while continuing to manage our reduced operating costs. There can be no assurance, however, as to either the timing or success of achieving these objectives, which, during any period not achieved, may cause us to experience a prolonged material and adverse impact on our business.

Even if we are successful in identifying and capturing additional revenue opportunities, we might be required to expand our overall production, development, marketing, sales, management and training capacity. 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.

**We terminated our bank credit facility agreements in September 2012. An inability to achieve anticipated cash flows from operations could have a material adverse effect on our liquidity and could require additional financing, which may not be available on acceptable terms or at all.**

Table of Contents

On August 30, 2012, we notified our former bank of our intent to terminate our then-existing credit facility agreements and repay the term loan in full, which amounted to \$685,000 at the time of its repayment in September 2012.

An inability to achieve anticipated cash flows from operations could have a material adverse effect on our ability to fund operations and require us to obtain new financing. However, there is no assurance that such financing will be available on acceptable terms, if at all.

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

In fiscal year 2014, we derived more than 77% of our revenue from sales of our medical device and motion control products and related services. We believe that a primary factor in the market acceptance of our products and services is the value they create for our customers. 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, while at the same time continuing to provide the value our customers have come to expect from us. We have historically expended a significant percentage of our revenue 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 the market does not continue to accept our existing products, or our new products or product enhancements do not achieve market acceptance, our business, results of operations and financial condition could be materially adversely affected.

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

The markets for products in the industries served by our customers 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 surgical device and motion control related companies. As a provider of outsourced products and services, we also compete with our customers' own internal development groups. Competitive pressures and other factors, such as new product or new technology introductions by us, our customers' internal development and manufacturing departments, 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.

**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 medical device and motion control 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 our 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.

Table of Contents

New product development requires significant research and development expenditures that we have historically funded through operations; however we may be unable to do so in the future and we have no credit facility with which to fund such expenditures. 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. Although we target new markets for access, develop new products and update existing products, there can be no assurance that we will do so successfully or that even if we are successful, such efforts 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 rely heavily on our proprietary technology, which, if not properly protected or if 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 proprietary technology and rely on patent filings, exclusive development and supply agreements, confidentiality procedures and employee nondisclosure agreements to protect it. 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. Assertions or claims by others, whether or not valid, could cause us to incur significant legal costs defending our intellectual property rights and potentially require us to enter into a license agreement or royalty arrangement with the party asserting the claim or to cease our use of the infringing technology, any of which could have a material adverse effect on our business, results of operations and financial condition.

**Two of our directors hold voting power with respect to a substantial portion of our outstanding common stock that enables them to have significant influence over the outcome of all matters submitted to our shareholders for approval, which influence may conflict with our interests and the interests of other shareholders.**

As of September 2, 2014, two of our directors, Nicholas J. Swenson and Raymond E. Cabillot, controlled voting power over approximately 36.8% (24.7% and 12.1%, respectively) of the outstanding shares of our common stock. As a result of such voting control, these directors will have significant influence over all matters submitted to our shareholders for approval, including the election of our directors and other corporate actions, and may have interests that conflict with our interests and the interests of other shareholders.

**A conflict of interest exists with respect to certain investments approved by our Investment Committee.**

We have a Surplus Capital Investment Policy (the "Policy") that provides, among other items, for the following:

- (a) Determination by our Board of Directors of (i) our surplus capital balance and (ii) the portion of such surplus capital balance to be invested according to the Policy;
- (b) Selection of an Investment Committee responsible for implementing the Policy; and
- (c) Objectives and criteria under which investments may be made.

The Investment Committee is currently comprised of: Messrs. Swenson (Chair) and Cabillot, both of whom are members of our Board of Directors and professional investment fund managers, and Mr. Harold A. Hurwitz, a member of our Board of Directors, and our Chief Executive Officer and Chief Financial Officer. The Investment



Committee has approved making investments in the common stocks of certain companies in which funds managed by Messrs. Swenson and/or Cabillot currently hold common stock investments, and may approve making additional such investments in the future. In such situations, a potential conflict of interest exists, or will exist, in that Messrs. Swenson's or Cabillot's interests may not be independent of Investment Committee decisions. As of August 31, 2014, the investments made pursuant to the Policy in equity securities of publicly held companies had an aggregate market value of approximately \$1.1 million.

Table of Contents

**Our investments under the Policy are concentrated in stocks whose fair values are subject to a loss in value and which may not easily be sold.**

Our current investments under the Policy include investments in common stocks of various companies. A significant decline in the value of our investments may produce a large decrease in our consolidated shareholders' equity and could have a material adverse effect on our consolidated book value per share. Under certain circumstances, significant declines in the fair value of these investments may require the recognition of losses in the statement of operations and other comprehensive income. In addition, some stocks in which we are invested under the Policy do not consistently trade on a daily basis which could adversely affect our ability to sell them on a timely basis or at an acceptable value. It is possible that we could realize a significant or complete loss of our investments under the Policy.

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

Our sales 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; changes in pricing policies or price reductions by us or our competitors; the timing of new product announcements and product introductions by us or our competitors; the financial stability of major customers; our success in expanding our sales and marketing programs; acceleration, deferral, or cancellation of customer orders and deliveries; changes in our strategy; revenue recognition policies in conformity with accounting principles generally accepted in the United States ("GAAP"); personnel changes; and general market and economic factors.

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

In addition, it is possible that our operating results in future quarters may be below the expectations of public market analysts and investors. In such an event, the price of our common stock could be materially adversely affected.

**Our operations are subject to a number of complex government regulations, the violation of which could have a material adverse effect on our business.**

The manufacture and distribution of medical and dental devices are subject to state and federal requirements set forth by various government agencies including the FDA and EPA. 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 the ongoing risk that one or more of our activities may at some point be determined to be 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, the costs to achieve such a determination and the intervening loss of business could adversely affect or result in the cessation of a portion of our business. A change in such laws or regulations at any time may have an adverse effect on our operations.

The FDA designates all medical devices into one of three classes (Class I, II or III) based on the level of control necessary to assure the safety and effectiveness of the device (with Class I requiring the lowest level of control and Class III requiring the greatest level of control). The surgical instrumentation we manufacture is generally classified

into Class I, and our dental instrumentation is generally classified into Class II. 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 are from time to time subject to routine governmental reviews and investigations. We are also subject to EPA regulations concerning the disposal of industrial waste.

While management believes that our products and processes fully comply with applicable laws and regulations, we are unable to predict the outcome of any such future review or investigation.

Table of Contents

**We face significant uncertainty in the healthcare industry due to government reform.**

Political, economic and regulatory influences are subjecting the healthcare industry to fundamental changes. The Affordable Care Act enacted sweeping reforms to the U.S. healthcare industry, including mandatory health insurance, reforms to Medicare and Medicaid, the creation of large insurance purchasing groups, new taxes on medical equipment manufacturers that apply to certain of our products and other significant modifications to the healthcare delivery system. Due to uncertainties regarding the ultimate features of federal legislation and its implementation, we cannot predict what impact the Affordable Care Act may have on us, our customers or our industry.

**The global economic environment may impact our business, operating results or financial condition.**

Changes in the global economic environment have caused, and may cause in the future, a general tightening in the credit markets, lower levels of liquidity, increases in rates of default and bankruptcy, and extreme volatility in credit, equity and fixed income markets. These macroeconomic developments could negatively affect our business, operating results or financial condition should they cause, for example, current or potential customers to become unable to fund purchases of our products, in turn resulting in delays, decreases or cancellations of purchases of our products and services, or causing the customer to not pay us or to delay paying us for previously purchased products and services. In addition, financial institution failures may cause us to incur increased expenses or make it more difficult either to obtain financing for our operations, investing activities (including the financing of any future acquisitions), or financing activities. Additional economic risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially and adversely affect our business, financial condition or operating results.

**We face risks and uncertainties associated with potential litigation by or 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.

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 will be found on a timely basis, if at all, to satisfy customer demands or to avoid potential claims or litigation. Also, due to the location of our facilities, as well as the nature of our business activities, there is a risk that we could be subject to litigation related to environmental remediation claims. We maintain insurance to protect against claims associated with the manufacture and use of our products, but there can be no assurance that our insurance coverage will adequately cover any claim asserted against us.

### Table of Contents

The uncertainty associated with potential litigation may have an adverse impact on our business. In particular, litigation could impair our relationships with existing customers and our ability to obtain new customers. Defending or prosecuting litigation could result in significant legal costs and a diversion of management's time and attention away from business operations, either of which could have a material adverse effect on our business, results of operations and financial condition. There can be no assurance that litigation would 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.

### **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 depends in significant part upon the continued service of our key technical and senior management personnel. Because we have a relatively small number of employees when compared to other 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 medical device 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 provide enhanced forms of incentive compensation to attract and retain such key personnel.

### **The failure to maintain the market price of our common stock may affect our ability to remain listed on the Nasdaq.**

The minimum bid price for our publicly traded common stock was below \$1.00 for a significant period of time throughout 2008, 2009 and 2010, ultimately resulting in us effecting a one-for-three reverse split of our common stock on June 17, 2010 to increase our stock price to satisfy the \$1.00 minimum bid price listing requirement of the Nasdaq Capital Market. Notwithstanding the increased price of our common stock that resulted from the reverse split, our future performance, general market conditions and other factors could result in us failing to satisfy the listing standards of the Nasdaq Capital Market in the future. If our common stock were to be delisted from the Nasdaq Capital Market, our shareholders may find it difficult to either dispose, or obtain quotations for the price, of our common stock.

### **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 standards that govern the measurement of our performance. Based on our reading and interpretations of relevant pronouncements, guidance, or concepts issued by, among other authorities, the Financial Accounting Standards Board, the SEC and the American Institute of Certified Public Accountants, management believes our performance, including current sales contract terms and business arrangements, has been properly reported. However, there continue to be issued pronouncements, 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 may 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 evaluation of internal controls and remediation of potential problems is costly and time consuming and could expose weaknesses in financial reporting.**

Section 404 of the Sarbanes-Oxley Act of 2002, as amended, requires management's assessment of the effectiveness of our internal control over financial reporting. This process is expensive and time consuming, and requires 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 and costly, and could 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.

10

Table of Contents

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

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 current base monthly lease rate of \$35,000, with annual increases of \$1,400 per month in the base lease rate through the expiration of the lease in April 2018. The building is a one-story stand-alone structure of concrete “tilt-up” construction, approximately 25 years old and in good condition.

Our Beaverton office and manufacturing facility is located at 15201 N.W. Greenbrier Parkway, B-1 Ridgeview, Beaverton, Oregon 97006. The Company executed a first amendment to the lease in the second quarter of fiscal year 2014 reducing the leased premises from 7,500 square feet to 7,100 square feet. The facility is leased from an unrelated third party, at a base monthly lease rate of \$5,900 through the expiration of the lease in July 2017. The building is a one-story suite in a 20-year-old industrial office complex and is in good condition.

The current leased facilities are believed to be adequate for our expected needs. We believe each facility is in full compliance with applicable state, EPA and other agency environmental standards.

ITEM 3. LEGAL PROCEEDINGS

We are from time to time a party to various legal proceedings incidental to our business, none of which we consider may be material. The legal proceedings potentially cover a variety of allegations spanning our entire business. There can be no certainty, however, that we may not ultimately incur liability or that such liability will not be material and adverse.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

Table of Contents

## PART II

## ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

## Market Information

Our common stock 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 of our common stock 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 8, 2014, the last sale price of our common stock as reported by NASDAQ was \$2.05 per share.

|                           | High   | Low    |
|---------------------------|--------|--------|
| Year ended June 30, 2013: |        |        |
| First Quarter             | \$2.10 | \$1.52 |
| Second Quarter            | 2.19   | 1.72   |
| Third Quarter             | 2.37   | 1.92   |
| Fourth Quarter            | 2.10   | 1.84   |
| Year ended June 30, 2014: |        |        |
| First Quarter             | \$2.10 | \$1.90 |
| Second Quarter            | 2.55   | 2.06   |
| Third Quarter             | 3.77   | 1.99   |
| Fourth Quarter            | 2.30   | 1.90   |

## Holders

As of September 8, 2014, there were 79 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.

## Dividends

We have never paid a cash dividend with respect to our common stock. The current policy of our Board of Directors is to retain any future earnings to provide funds for the operation and expansion of our business. Any determinations to pay dividends in the future will be at the discretion of our Board of Directors.

## Rights Offering

On April 30, 2014 we completed a rights offering whereby we issued a total of 868,732 shares of common stock. The rights offering was made pursuant to a Registration Statement on Form S-3 that was filed with the Securities and Exchange Commission ("SEC") and became effective on March 21, 2014. The rights offering was made through the Company's distribution to its existing shareholders as of March 20, 2014, the record date, of non-transferable subscription rights to purchase their pro rata portion of newly issued shares of common stock at a subscription price of \$1.90 per share. The subscription period commenced on March 24, 2014 and expired on April 25, 2014. (See Note 12 of Notes to Consolidated Financial Statements contained elsewhere in this report.)



Repurchases

We did not repurchase any securities during fiscal 2014 or fiscal 2013.

Table of Contents

ITEM 6. SELECTED FINANCIAL DATA

Not applicable.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our financial condition and results of operations should be read in conjunction with our Consolidated Financial Statements and the Notes thereto included in Item 8 of this report as well as the Risk Factors included in Item 1A of this report. The following discussion contains forward-looking statements. (See "Cautionary Note Regarding Forward-Looking Statements" included in Item 1 of this report.)

Overview

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 the years ended June 30, 2014 and 2013. Unless otherwise indicated, this discussion excludes the results of our fractional horsepower motor product line, operating under the name Pro-Dex Astromec, which we sold in February 2012 and which has been classified as a discontinued operation.

The Company, with operations in Irvine, California and Beaverton, Oregon, designs and produces powered surgical and dental instruments and motion control products used in the medical, factory automation and scientific research industries.

Our products are found in hospitals, dental offices, medical engineering labs, scientific research facilities and high-tech manufacturing operations around the world. In addition to Pro-Dex, the names Micro Motors and Oregon Micro Systems are used for marketing purposes as brand names.

Critical Accounting Policies

Our consolidated financial statements are prepared in accordance with 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.

**Revenue Recognition**

Revenue on product sales is recognized upon shipment to the customer when risk of loss and title transfer to the customer and all other conditions required by GAAP, as promulgated by the Financial Accounting Standards Board ("FASB") in Accounting Standards Codification ("ASC") Section 605 (formerly Staff Accounting Bulletin No. 104, *Revenue Recognition*), have been satisfied.

Revenue from billable product development service portions of development and supply contracts is generally recognized upon completion of such product development services, in conformity with ASC Section 605. Accordingly, revenue from product development milestone billings to our customers under such contracts is deferred.

Returns of our product for credit are minimal; accordingly, we do not establish a reserve for product returns at the time of sale.

#### Estimated Losses on Product Development Services

Cost and revenue estimates related to the product development service portions of development and supply contracts are reviewed and updated quarterly. When it is probable that total costs from the development portion of such contracts will exceed product development service revenue, the expected loss is recognized immediately in cost of sales.

### Table of Contents

Owing to the complexity of many of the contracts we have undertaken, the cost estimation process requires significant judgment. It is based upon the knowledge and experience of our project managers, engineers, and finance professionals. Factors that are considered in estimating the cost of work to be completed and ultimate profitability of the fixed price product development portion of development and supply contracts include the nature and complexity of the work to be performed, availability and productivity of labor, the effect of change orders, the availability of materials, performance of subcontractors, and expected costs for specific regulatory approvals.

### **Warranties**

Certain of our products are sold with a warranty that provides for repairs or replacement of any defective parts for a period, generally one to two years, after the sale. At the time of the sale, we accrue an estimate of the cost of providing the warranty based on prior experience with such factors as return rates and repair costs, which factors are reviewed quarterly.

Warranty expenses, including changes of estimates, are included in cost of sales in our consolidated statements of operations.

### **Inventories**

Inventories are stated at the lower of cost (first-in, first-out method) or market value. Reductions to estimated market value are recorded, and charged to cost of sales, when indicated based on a formula that compares on-hand quantities to both historical usage and estimated demand over the ensuing 12 months from the measurement date.

### **Accounts Receivable and Unbilled Receivables**

Trade receivables are stated at their original invoice amounts, less an allowance for doubtful portions of such accounts. Management determines the allowance for doubtful accounts based on facts and circumstances related to specific accounts, and on historical experience related to the age of accounts. Trade receivables are written off when deemed uncollectible. Recoveries of trade receivables previously reserved are offset against the allowance when received.

Unbilled receivables reflect revenues from non-recurring engineering services not yet billable to customers under the terms of the related development and supply contracts.

### **Investments**

Investments consist of marketable equity securities of publicly held companies. Management intends to hold such securities for a sufficient period in which to realize a reasonable return, although there is no assurance that positive returns will be realized or that such securities will not be liquidated in a shorter than expected time frame to accommodate the Company's liquidity requirements. Accordingly, investments have been classified as non-current and available-for-sale in conformity with ASC Section 320. Investments are marked to market at each measurement date, with unrealized gains and losses presented as adjustments to accumulated other comprehensive income or loss.

### **Long-lived Assets**

We review the recoverability of long-lived assets, consisting of equipment and leasehold improvements, when events or changes in circumstances occur that indicate carrying values may not be recoverable.

### **Share-Based Compensation**

We recognize compensation expense for all share-based awards made to employees and directors. The fair value of share-based awards is estimated at the grant date using the Black-Scholes option-pricing model. The portion that is ultimately expected to vest is recognized as compensation cost over the requisite service period using the straight-line single option method.

14

Table of Contents

The determination of fair value using the Black-Scholes model is affected by our stock price as well as assumptions regarding a number of complex and subjective variables, including expected stock price volatility, risk-free interest rate, expected dividends and projected employee stock option exercise behavior. We estimate stock price volatility based on two factors: (a) the measurement date (typically the grant date) and (b) the expected life of the option, which we calculate using the Staff Accounting Bulletin No. 107 simplified method.

**Income Taxes**

We recognize deferred tax assets and liabilities for temporary differences between the financial reporting basis and the tax basis of our assets and liabilities along with net operating loss and tax credit carryovers. Deferred tax assets at June 30, 2014 and 2013 consisted primarily of basis differences related to research and development tax credit utilization, net operating loss carryovers, intangible assets, accrued expenses and inventories.

Significant management judgment is required in determining our provision for income taxes and the recoverability of our deferred tax assets. Such determination is based on our historical taxable income, with consideration given to our estimates of future taxable income and the periods over which deferred tax assets will be recoverable. We record a valuation allowance against deferred tax assets to reduce the net carrying value to an amount that we believe is more likely than not to be realized. When we establish or reduce the valuation allowance against deferred tax assets, the provision for income taxes will increase or decrease, respectively, in the period such determination is made. At June 30, 2014 and 2013, we maintained a valuation allowance against the entire balance of our deferred tax assets, net of deferred tax liabilities.

## Results of Operations for the Fiscal Year Ended June 30, 2014 Compared to the Fiscal Year Ended June 30, 2013

The following tables set forth results from continuing operations for the years ended June 30, 2014 and 2013:

|   | Years Ended June 30, |            |                      |                      |
|---|----------------------|------------|----------------------|----------------------|
|   | 2014                 | 2013       | % of<br>Net<br>Sales | % of<br>Net<br>Sales |
|   | Dollars in thousands |            |                      |                      |
| Net sales   | \$10,812             | \$12,249   | 100%                 | 100%                 |
| Cost of sales                                       | 7,846                | 8,533      | 73%                  | 70%                  |
| Gross profit  | 2,966                | 3,716      | 27%                  | 30%                  |
| Selling expenses                                    | 585                  | 1,255      | 5%                   | 10%                  |
| General and administrative expenses                 | 1,713                | 2,566      | 16%                  | 21%                  |
| Research and development costs                      | 1,482                | 1,790      | 14%                  | 15%                  |
|   | 3,780                | 5,611      | 35%                  | 46%                  |
| Operating loss                                      | (814 )               | (1,895 )   | (8% )                | (15% )               |
| Other income (expense), net                         | 59                   | (8 )       | 1%                   | —                    |
| Loss from continuing operations before income taxes | (755 )               | (1,903 )   | (7% )                | (16% )               |
| Benefit from income taxes                           | 104                  | 39         | 1%                   | 1%                   |
| Net loss from continuing operations                 | \$(651 )             | \$(1,864 ) | (6% )                | (15% )               |

**Net Sales**

The majority of our revenue is derived from designing, developing and manufacturing powered surgical instruments for medical device original equipment manufacturers, dental instruments, and motion control software and hardware for industrial and scientific applications. The proportion of total sales by customer type is as follows:

15

Table of Contents

|                           | Years Ended June 30, |                   |          |                   | Increase<br>(Decrease)<br>From 2013<br>To 2014 |
|---------------------------|----------------------|-------------------|----------|-------------------|--|
|                           | 2014                 | 2013              |          |                   |  |
|                           | Dollars in thousands |                   |          |                   |  |
|                           |                      | % of Net<br>Sales |          | % of Net<br>Sales |  |
| Net sales:                |                      |                   |          |                   |  |
| Medical device            | \$6,848              | 64%               | \$7,970  | 65%               | (14%)  |
| Industrial and scientific | 2,392                | 22%               | 2,594    | 21%               | (8%)   |
| Dental                    | 1,219                | 11%               | 1,092    | 9%                | 12%  |
| Government and other      | 353                  | 3%                | 593      | 5%                | (40%)  |
|                           | \$10,812             | 100%              | \$12,249 | 100%              | (12%)  |

Net sales in fiscal 2014 decreased by \$1.4 million, or 12%, as compared to fiscal 2013, due primarily to a reduction in medical device sales of \$1.1 million. Shipments to our largest customer, accounted for in medical device sales, decreased \$491,000 for fiscal 2014 from fiscal 2013. This decrease resulted from the customer's suspension of product delivery orders during the first five months of fiscal 2014, and the negotiation in December 2013 of a revised delivery schedule that provided for an extension, into fiscal 2015, of the number of months in which the customer would fulfill its ordering obligation. Additionally, repair sales of \$294,000 to our former largest medical device customer in fiscal 2014 represented a decline of approximately \$428,000 from fiscal 2013, and we do not expect to receive further repair orders from this former customer.

At June 30, 2014, we had a backlog of \$2.8 million compared with a backlog of \$6.7 million at June 30, 2013. We may experience variability in our new order bookings due to, among other reasons, the timing of customer orders based on end-user demand and customer inventory levels, illustrative of which is our receipt in July 2014 of purchase orders from our largest customer aggregating approximately \$3.5 million for shipments extending through December 2015.

**Cost of Sales and Gross Margin**

|  | Years Ended June 30, |                   |         |                   | Increase<br>(Decrease)<br>From 2013<br>To 2014 |
|--|----------------------|-------------------|---------|-------------------|--|
|  | 2014                 | 2013              |         |                   |  |
|  | Dollars in thousands |                   |         |                   |  |
|  |                      | % of Net<br>Sales |         | % of Net<br>Sales |  |
| Cost of sales:                                 |                      |                   |         |                   |  |
| Product costs                                  | \$6,867              | 64%               | \$7,224 | 59%               | (5%)   |
| Accrued losses on product development services | 317                  | 3%                | 176     | 2%                | 80%  |
| Under-absorption of manufacturing costs        | 474                  | 4%                | 465     | 4%                | 2%   |
| Inventory and warranty charges                 | 188                  | 2%                | 668     | 5%                | (72%)  |
| Total cost of sales                            | \$7,846              | 73%               | \$8,533 | 70%               | (8%)   |
| Gross profit and gross margin                  | \$2,966              | 27%               | \$3,716 | 30%               | (20%)  |



Cost of sales in fiscal 2014 decreased \$687,000, or 8%, from fiscal 2013, due primarily to (a) a \$357,000 decrease in product costs, and (b) a \$480,000 decrease in expenses related to inventory and warranty charges, partially offset by (c) a \$141,000 increase from fiscal 2013 to 2014 in accruals for anticipated losses on fixed price product development services portion of certain contracts. The decrease in product costs is due primarily to the decrease in net sales from fiscal 2013 to 2014. The decrease in costs related to inventory allowances and warranty charges in fiscal 2014 compared to 2013 is due primarily to the decrease in sales to our largest medical device customer, as well as a reduction in both the number of units returned under warranty and the average per unit repair cost in fiscal 2014 compared to fiscal 2013.

Table of Contents

Gross margin declined three percentage points from 30% in fiscal 2013 to 27% in fiscal 2014. Contributing to this decline are (a) the increase from fiscal 2013 to 2014 in accruals of anticipated losses related to certain product development contracts as described in the preceding paragraph, and (b) higher under-absorbed manufacturing overhead costs as a percentage of sales in fiscal 2014, relative to 2013, partially offset by (c) the reduced warranty costs as described in the preceding paragraph.

**Operating Expenses**

|                                     | <b>Years Ended June 30,</b>   |             |                           |     | <b>Increase<br/>(Decrease)<br/>From 2013<br/>To 2014</b> |
|-------------------------------------|-------------------------------|-------------|---------------------------|-----|--|
|                                     | <b>2014</b>                   | <b>2013</b> |                           |     |  |
|                                     | <b>(Dollars in thousands)</b> |             |                           |     |  |
|                                     | <b>% of Net<br/>Sales</b>     |             | <b>% of Net<br/>Sales</b> |     |  |
| Operating expenses:                 |                               |             |                           |     |  |
| Selling expenses                    | \$585                         | 5%          | \$1,255                   | 10% | (53%)  |
| General and administrative expenses | 1,713                         | 16%         | 2,566                     | 21% | (33%)  |
| Research and development costs      | 1,482                         | 14%         | 1,790                     | 15% | (17%)  |
|                                     | \$3,780                       | 35%         | \$5,611                   | 46% | (33%)  |

Selling expenses consist of salaries and other personnel-related expenses related to business development department, as well as trade show attendance, advertising and marketing expenses, and travel and related costs incurred in generating and maintaining customer relationships. The decrease in selling expenses of \$670,000 in fiscal 2014 from fiscal 2013 relates primarily to decreases in personnel-related costs of \$451,000, and advertising and trade show related expenses of \$173,000.

General and administrative expenses (“G&A”) consist of salaries and other personnel-related expenses for corporate, accounting and finance personnel, as well as costs for outsourced human resource and information technology services, professional fees, directors’ fees and costs associated with being a public company. The \$853,000 decrease in G&A expenses from fiscal 2013 to 2014 is due primarily to (a) decreased personnel costs of \$274,000, of which \$167,000 relates to a severance payment made in fiscal 2013 for our former Chief Executive Officer, (b) lower public company related costs in fiscal 2014, relative to 2013, due to costs incurred in 2013 amounting to \$190,000 associated with the contested election of directors at our 2012 Annual Meeting of Shareholders held in January 2013 that were not incurred in 2014, (c) reduced professional service fees, including legal expenses, board of director fees, and stock compensation expenses of \$233,000, \$60,000 and \$50,000, respectively.

Research and development costs consist of salaries and other personnel-related costs of our product development and engineering personnel, related professional and consulting fees, and costs related to intellectual property, laboratory usage, materials, and travel and related costs incurred in the development and support of our products. The decrease in research and development costs in fiscal 2014 as compared to 2013 is primarily due to (a) reduced expenditures on internal projects in the amount of \$96,000, (b) the increased utilization of engineering resources in contractual development projects of \$241,000, the costs of which are reflected in unbilled receivables at June 30, 2014, (c) reduced consulting and recruiting expenses of \$59,000, and (d) reduced supplies, travel and dues of \$39,000, offset by increased personnel costs of \$151,000, of which \$53,000 were severance costs.

**Other Income (Expense), Net**

Other income and expense consists of interest income earned from our money market account, interest expense related to capital lease obligations for leased office equipment, and realized gains and losses from sales of investments in marketable equity securities. The increase in other income (expense), net in fiscal 2014 as compared to 2013 is due primarily to realized gains, amounting to \$65,000, from sales of certain investments in marketable equity securities. There were no sales of investments during fiscal 2013.

Table of Contents**Benefit from Income Taxes**

The effective tax rates for fiscal 2014 and 2013 are lower than statutory tax rates due to our inability to fully recognize the benefits of federal and state loss carryforwards prior to their utilization. (See Note 7 of Notes to Consolidated Financial Statements contained elsewhere in this report).

**Liquidity and Capital Resources**

The following table is a summary of our Consolidated Statements of Cash Flows and Cash and Working Capital:

|   | As of and for the<br>Years<br>Ended June 30,<br>2014 2013<br>(In thousands) |           |
|---|---|-----------|
| Cash provided by (used in):                 |   |           |
| Operating activities                        | \$(329 )  | \$(1,271) |
| Investing activities                        | \$323   | \$(452 )  |
| Financing activities                        | \$1,514   | \$(709 )  |
| Cash, cash equivalents and working capital: |   |           |
| Cash and cash equivalents                   | \$3,188   | \$1,680   |
| Working capital                             | \$6,766   | \$5,033   |

**Cash Flows from Operating Activities**

Cash used in operating activities during fiscal 2014 was \$329,000. The primary uses of cash arose from (a) the net loss for the year of \$488,000, which was offset by non-cash depreciation and amortization of \$527,000, (b) an increase in accounts receivable of \$440,000 related to the resumption of product delivery orders during fiscal 2014 from our largest customer, which orders had been suspended at June 30, 2013, (c) an increase in unbilled receivables of \$828,000 related to the product development portion of certain contracts in progress at June 30, 2014, and (d) an aggregate decrease of \$313,000 in accounts payable, accrued expenses and deferred rent. The primary source of cash was a \$1.2 million reduction of inventory, which had been built up at the end of the fiscal 2013 as a result of the suspension of product delivery orders from our largest customer. With the resumption of the customer's orders in December 2013, this inventory build-up was substantially consumed as of June 30, 2014.

Net cash used in operating activities in 2013 amounted to \$1.3 million. The primary uses of cash arose from (a) the net loss for the year of \$1.8 million, partially offset by non-cash charges for depreciation and amortization, share-based compensation and allowance for doubtful accounts aggregating \$690,000, (b) an increase in unbilled receivables amounting to \$244,000 relating to the development portion of certain contracts we entered into with customers in 2013, and (c) an increase in inventories of \$1.0 million, resulting primarily from a build-up of our stock of components related to certain of our products with the objective of shortening lead times when forecasted purchase orders are received. In the fourth quarter of 2013, our largest customer began deferring the timing of its product delivery orders, thus prolonging the effect of the inventory build-up described above with respect to inventory unique

to that customer's products. Sources of cash arose primarily from (a) a reduction in accounts receivable amounting to \$325,000, attributable primarily to the lower sales volume experienced during 2013 relative to 2012, and (b) a reduction in income taxes receivable amounting to \$608,000, resulting primarily from tax refunds received in 2013 from the carryback of tax-basis net operating losses generated in 2012, (c) an increase of \$69,000 in accounts payable, accrued expenses and deferred rent, and (d) an increase in deferred revenue amounting to \$121,000, resulting from collections received in 2013 from customers in connection with the contractual terms of development contracts that will not qualify for revenue recognition until we complete the related non-recurring engineering services.

## Table of Contents

### Cash Flows from Investing Activities

Net cash provided by investing activities in fiscal 2014 was \$323,000. Sources of cash arose from (a) \$900,000 of proceeds received from the sale of the land and building housing our former Astromec operations, and (b) \$228,000 of proceeds received from the sale of investments in common stock of public companies under the direction of the Investment Committee of our Board (see “Surplus Capital Investment Policy” below). Uses of cash consisted of (a) investments, aggregating \$654,000, in marketable equity securities of publicly held companies, (b) costs of internally developed software and intellectual property amounting to \$105,000, and (c) purchases of equipment amounting to \$50,000.

Net cash used in investing activities during fiscal 2013 consisted primarily of investments, aggregating \$366,000, in marketable equity securities of publicly held companies and purchases of equipment amounting to \$86,000.

### Cash Flows from Financing Activities

Cash provided from financing activities during fiscal 2014 was \$1.5 million and consisted almost entirely of our completion of a common stock rights offering, which raised net proceeds of \$1.5 million after deducting legal, accounting and other related fees (see “Rights Offering” below).

Net cash used in financing activities for fiscal 2013 consisted primarily of (a) our payment, in September 2012, of the remaining balance due, amounting to \$685,000, on the Union Bank term loan, fully retiring such indebtedness (see Note 5 of Notes to Condensed Consolidated Financial Statements contained elsewhere in this report), and (b) normal reductions in the principal balance of the bank term loan, prior to the repayment described above, of \$90,000. These uses were partially offset by \$66,000 in proceeds from the exercise of stock options.

We believe that our existing cash and cash equivalent balances and investments in equity securities will be sufficient to fund our operations for the next twelve months.

### Changes in Bank Debt and Credit Facilities

In September 2012, we terminated a bank credit facility and, in connection with such termination, repaid the entire principal balance of a term loan, amounting to \$685,000.

As a result of the foregoing, we no longer have a credit facility with a financial institution. Should we be unable to achieve anticipated cash flows from operations, we may be required to seek new financing. However, there is no assurance that such financing will be available on acceptable terms, if at all.

### Reduction in Directors' Compensation

At our 2012 Annual Meeting held on January 17, 2013, our shareholders elected four new members to our Board of Directors. At a meeting of the newly constituted Board on February 4, 2013, three of those newly elected directors, Messrs. Swenson, Cabillot and Farrell, each opted to waive, through the date of our 2013 Annual Meeting of Shareholders, (a) receipt of stock options they were otherwise entitled to receive under the provisions of the directors' compensation plan then in effect (the "2010 Plan"), and (b) any cash retainers or meeting fees they were otherwise entitled to receive under the 2010 Plan in excess of \$200 per meeting and \$2,000 per year.

At its meeting on May 2, 2013, our Board replaced the 2010 Plan with the 2013 Directors' Compensation Plan (the "2013 Plan") that provides for the following:

- Fees of \$200 for participation in Board or Committee meetings, to a maximum of \$2,000 per fiscal year;
- An annual retainer of \$23,000 for the Audit Committee Chair (which may be modified in compensating any future Audit Committee Chair)

### Table of Contents

The 2013 Plan has no provision for (a) retainers other than that described above, or (b) grants of options to purchase shares of our common stock.

### Surplus Capital Investment Policy

The Policy provides, among other items, for the following:

- (a) Determination by our Board of Directors of (i) our surplus capital balance and (ii) the portion of such surplus capital balance to be invested according to the Policy;
- (b) Selection of an Investment Committee responsible for implementing the Policy; and
- (c) Objectives and criteria under which investments may be made.

The Investment Committee is comprised of Messrs. Swenson (Chair), Cabillot and Hurwitz.

In June 2013, the Investment Committee approved investments aggregating \$500,000, and approved an additional \$500,000 in July 2013. Additionally, in May 2014 the Investment Committee approved the transfer to our money market account of \$1,650,000, representing the gross proceeds from the common stock rights offering. At June 30, 2014, \$857,000 had been invested in marketable public equity securities, having a market value at June 30, 2014 of \$1,058,000, and \$1,871,000 was invested in money market funds. Additionally, during the fiscal year ended June 30, 2014, we sold equity securities with a cost basis of \$163,000, for \$228,000, resulting in a realized gain of \$65,000.

In September 2013, our Board of Directors approved a share repurchase program authorizing the Company, at the direction of the Investment Committee, to repurchase up to 750,000 shares of our common stock under parameters to be determined by the Investment Committee. The repurchase program has no stated expiration date and there have been no repurchases under the program.

### Rights Offering

We commenced a common stock rights offering on March 24, 2014, pursuant to a registration statement on Form S-3 filed with the SEC. The rights offering was made through the distribution to our existing shareholders as of March 20, 2014 of non-transferable subscription rights to purchase their pro rata portion of newly issued shares of our Common Stock (the "Subscription Privilege") at a price of \$1.90 per share (the "Subscription Price"). The subscription period for exercise of the rights commenced on March 24, 2014 and expired on April 25, 2014.

Upon completion of the rights offering, we received gross proceeds of approximately \$1.65 million before estimated expenses of \$140,000, through shareholder subscriptions for 868,732 shares of common stock.

Of the total amount of shares issued, 317,231 and 156,189 shares were issued to AO Partners I, LP ("AO Partners") and Farnam Street Partners, L.P. ("Farnam Street Partners"), respectively, the Company's two largest shareholders, who each exercised its full pro-rata allotment of rights in the offering. AO Partners, LLC is the General Partner of AO Partners, and Nicholas J. Swenson, a director of the Company, is the Managing Member of AO Partners. Raymond E. Cabillot, also a director of the Company, is the CEO of Farnam Street Partners.



In connection with the rights offering, we entered into a Standby Purchase Agreement (the “Standby Purchase Agreement”) with AO Partners, LLC and Farnam Street Capital, Inc. (each a beneficial shareholder of our common stock; each a “Standby Purchaser” and collectively the “Standby Purchasers”) pursuant to which the Standby Purchasers agreed to purchase, at the Subscription Price, any and all shares of Common Stock not subscribed for by shareholders in connection with the rights offering, subject to reduction by us as described below. Messrs. Swenson and Cabillot have the power to direct the affairs of AO Partners, LLC and Farnam Street Capital, Inc., respectively. No fees or other consideration were paid by us to the Standby Purchasers in exchange for their commitment to purchase any and all unsubscribed shares of Common Stock following the rights offering.

## Table of Contents

In the event that the exercise by a shareholder of the Subscription Privilege or the purchase of our common stock under the Standby Purchase Agreement could, in our sole discretion, have potentially resulted in a limitation of our ability to utilize our tax attributes, such as the annual utilization of net operating loss or tax credit carry forwards, we had the ability to reduce the exercise by such shareholder of the Subscription Privilege or the amount purchased under the Standby Purchase Agreement to such number of shares of our Common Stock as we determined advisable in order to preserve our ability to utilize such tax attributes. On the basis of the Company's analysis of tax attributes, the Company did not reduce the subscriptions of any shareholder in the rights offering, but did reduce to zero the number of shares the Standby Purchasers could have otherwise purchased pursuant to the Standby Purchase Agreement. As a result, no shares were issued to AO Partners, LLC or Farnam Street Capital, Inc. pursuant to the Standby Purchase Agreement.

We intend to use the net proceeds of the rights offering to pursue strategic opportunities that may present themselves from time to time or, if not used to pursue strategic opportunities, for working capital and general corporate purposes, including to fund ongoing research and development and product initiatives. Also, to the extent the net proceeds are not deployed, some of the funds may be invested in accordance with the terms of our Surplus Capital Investment Policy.

## Recent Accounting Pronouncements

In May 2014, the FASB issued Accounting Standards Update ("ASU") 2014-09, "Revenue from Contracts with Customers," which outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. ASU 2014-09 requires an entity to recognize revenue depicting the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 will also result in enhanced revenue related disclosures. ASU 2014-09 is effective for fiscal years, and interim reporting periods within those years, beginning after December 15, 2016. We have not yet determined the impact of ASU 2014-09 on our consolidated results of operations, financial condition, or cash flows.

In April 2014, the FASB issued ASU 2014-08, "Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity." ASU 2014-08 requires that a disposal representing a strategic shift that has (or will have) a major effect on an entity's financial results or a business activity classified as held for sale should be reported as discontinued operations. ASU 2014-08 also expands the disclosure requirements for discontinued operations and adds new disclosures for individually significant dispositions that do not qualify as discontinued operations. ASU 2014-08 is effective prospectively for fiscal years, and interim reporting periods within those years, beginning after December 15, 2014. The impact of ASU 2014-08 is dependent upon the nature of dispositions, if any, after adoption.

## ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

Table of Contents

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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

**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

|  | Page |
|--|------|
| Report of Independent Registered Public Accounting Firm  | 23   |
| Financial Statements:  |      |
| Consolidated Balance Sheets, June 30, 2014 and 2013  | 24   |
| Consolidated Statements of Operations and Comprehensive Loss, Years Ended June 30, 2014 and 2013 | 25   |
| Consolidated Statements of Shareholders' Equity, Years Ended June 30, 2014 and 2013              | 26   |
| Consolidated Statements of Cash Flows, Years Ended June 30, 2014 and 2013                        | 27   |
| Notes to Consolidated Financial Statements   | 28   |

Table of Contents

**Report of Independent Registered Public Accounting Firm**

The Shareholders and Board of Directors

Pro-Dex, Inc.

We have audited the accompanying consolidated balance sheets of Pro-Dex, Inc. and Subsidiaries (the “Company”) as of June 30, 2014 and 2013 and the related consolidated statements of operations and comprehensive loss, shareholders’ equity and cash flows for each of the years in the two-year period ended June 30, 2014. 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 audit 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, 2014 and 2013, and the results of their operations and their cash flows for each of the years in the two-year period ended June 30, 2014 in conformity with accounting principles generally accepted in the United States of America.

*/s/ Moss Adams LLP*  
Moss Adams LLP  
Irvine, California  
September 18, 2014

Table of Contents**PRO-DEX, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****(In thousands, except share data)**

|   | June 30, |          |
|---|----------|----------|
|   | 2014     | 2013     |
| <b>ASSETS</b>   |          |          |
| Current assets:   |          |          |
| Cash and cash equivalents   | \$3,188  | \$1,680  |
| Accounts receivable, net of allowance for doubtful accounts of \$29 and \$24  | 1,776    | 1,339    |
| Unbilled receivables  | 1,073    | 244      |
| Other current receivables   | 31       | 34       |
| Inventory   | 2,600    | 3,834    |
| Prepaid expenses  | 110      | 157      |
| Deferred income taxes   | 115      | 59       |
| Total current assets  | 8,893    | 7,347    |
| Investments   | 1,058    | 370      |
| Plant, equipment and leasehold improvements, net  | 1,575    | 2,065    |
| Real estate held for sale   | —        | 733      |
| Intangibles   | 105      | —        |
| Other assets  | 77       | 80       |
| Total assets  | \$11,708 | \$10,595 |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |          |          |
| Current liabilities:  |          |          |
| Accounts payable  | \$744    | \$844    |
| Accrued liabilities   | 1,090    | 1,276    |
| Deferred revenue  | 232      | 141      |
| Income taxes payable  | 53       | 48       |
| Capital lease obligations   | 8        | 5        |
| Total current liabilities   | 2,127    | 2,314    |
| Non-current liabilities:  |          |          |
| Deferred income taxes   | 115      | 59       |
| Deferred rent   | 243      | 270      |
| Capital lease obligations, net of current portion   | 7        | 15       |
| Total non-current liabilities   | 365      | 344      |
| Total liabilities   | 2,492    | 2,658    |
| Commitments and Contingencies   |          |          |
| Shareholders' equity:   |          |          |
| Common stock, no par value, 50,000,000 shares authorized; 4,211,019 and 3,348,184 shares issued and outstanding at June 30, 2014 and 2013, respectively | 18,582   | 17,012   |
| Accumulated other comprehensive income  | 202      | 5        |
| Accumulated deficit   | (9,568 ) | (9,080 ) |

|  |          |          |
|--|----------|----------|
| Total shareholders' equity                 | 9,216    | 7,937    |
| Total liabilities and shareholders' equity | \$11,708 | \$10,595 |

*See notes to consolidated financial statements.*

Table of Contents**PRO-DEX, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS****(In thousands, except per share data)**

|  | Years Ended June 30, |            |
|--|----------------------|------------|
|  | 2014                 | 2013       |
| Net sales  | \$10,812             | \$12,249   |
| Cost of sales  | 7,846                | 8,533      |
| Gross profit   | 2,966                | 3,716      |
| Operating expenses:                                      |                      |            |
| Selling expenses   | 585                  | 1,255      |
| General and administrative expenses                      | 1,713                | 2,566      |
| Research and development costs                           | 1,482                | 1,790      |
| Total operating expenses                                 | 3,780                | 5,611      |
| Operating loss   | (814 )               | (1,895 )   |
| Other income (expense):                                  |                      |            |
| Interest income  | 12                   | 3          |
| Realized gain on sale of investments                     | 65                   | —          |
| Loss on sale of equipment                                | (10 )                | —          |
| Interest expense   | (8 )                 | (11 )      |
| Total other income (expense)                             | 59                   | (8 )       |
| Loss from continuing operations before income taxes      | (755 )               | (1,903 )   |
| Benefit from income taxes                                | 104                  | 39         |
| Net loss from continuing operations                      | (651 )               | (1,864 )   |
| Income from discontinued operations, net of income taxes | 163                  | 80         |
| Net loss   | \$(488 )             | \$(1,784 ) |
| Other comprehensive income, net of tax:                  |                      |            |
| Unrealized gain from marketable equity investments       | 262                  | 5          |
| Less: Reclassification of gains included in net loss     | (65 )                | —          |
| Comprehensive loss                                       | \$(291 )             | \$(1,779 ) |
| Basic and diluted income (loss) per share:               |                      |            |
| Net loss from continuing operations                      | \$(0.19 )            | \$(0.56 )  |
| Income from discontinued operations                      | 0.05                 | 0.02       |
| Net loss   | \$(0.14 )            | \$(0.54 )  |
| Weighted average common shares outstanding               | 3,493,151            | 3,321,732  |

*See notes to consolidated financial statements.*

25



Table of Contents**PRO-DEX, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY****For The Years Ended June 30, 2014 and 2013****(In thousands, except share data)**

|  | Common Shares       |          | Accumulated<br>Other<br>Comprehensive<br>Income | Accumulated<br>Deficit | Total   |
|--|---------------------|----------|---|------------------------|---------|
|  | Number of<br>Shares | Amount   |   |                        |         |
| Balance at June 30, 2012                           | 3,272,350           | \$16,846 | \$ —  | \$ (7,296 )            | \$9,550 |
| Net loss   | —                   | —        | —   | (1,784 )               | (1,784) |
| Exercise of stock options                          | 43,334              | 66       | —   | —                      | 66      |
| Unrealized gain from marketable equity investments | —                   | —        | 5   | —                      | 5       |
| Share-based compensation plan activity             | 32,500              | 100      | —   | —                      | 100     |
| Balance at June 30, 2013                           | 3,348,184           | \$17,012 | \$ 5  | \$ (9,080 )            | \$7,937 |
| Net loss   | —                   | —        | —   | (488 )                 | (488 )  |
| Issuance of common stock from rights offering      | 868,732             | 1,514    | —   | —                      | 1,514   |
| Exercise of stock options                          | 4,104               | 6        | —   | —                      | 6       |
| Unrealized gain from marketable equity investments | —                   | —        | 197   | —                      | 197     |
| Share-based compensation plan activity             | (10,001 )           | 50       | —   | —                      | 50      |
| Balance at June 30, 2014                           | 4,211,019           | \$18,582 | \$ 202  | \$ (9,568 )            | \$9,216 |

*See notes to consolidated financial statements.*

Table of Contents**PRO-DEX, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)**

|  | Years Ended June<br>30, |           |
|--|-------------------------|-----------|
|  | 2014                    | 2013      |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>   |                         |           |
| Net loss   | \$(488 )                | \$(1,784) |
| Adjustments to reconcile net loss to net cash used in continuing operating activities: |                         |           |
| Depreciation and amortization  | 527                     | 582       |
| Gain on sale of real estate held for sale  | (167 )                  | —         |
| Loss on sale or disposal of equipment  | 10                      | —         |
| Realized gain on sale of investments   | (65 )                   | —         |
| Share-based compensation   | 50                      | 100       |
| Allowance for doubtful accounts  | 5                       | 8         |
| Changes in operating assets and liabilities:   |                         |           |
| Accounts receivable and other receivables  | (440 )                  | 325       |
| Unbilled receivables   | (828 )                  | (244 )    |
| Inventory  | 1,234                   | (1,043)   |
| Prepaid expenses and other assets  | 50                      | (13 )     |
| Accounts payable, accrued expenses and deferred rent                                   | (313 )                  | 69        |
| Deferred revenue   | 91                      | 121       |
| Income taxes receivable and payable  | 5                       | 608       |
| Net cash used in operating activities  | (329 )                  | (1,271)   |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>   |                         |           |
| Purchases of equipment   | (50 )                   | (86 )     |
| Proceeds from sale of real estate held for sale  | 900                     | —         |
| Proceeds from sale of equipment  | 4                       | —         |
| Proceeds from sale of investments  | 228                     | —         |
| Increase in intangibles  | (105 )                  | —         |
| Purchase of investments  | (654 )                  | (366 )    |
| Net cash provided by (used in) investing activities                                    | 323                     | (452 )    |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>   |                         |           |
| Principal payments on capital lease and bank term loan                                 | (5 )                    | (775 )    |
| Net proceeds received from common stock rights offering                                | 1,513                   | —         |
| Proceeds from exercise of stock options  | 6                       | 66        |
| Net cash provided by (used in) financing activities                                    | 1,514                   | (709 )    |
| Net increase (decrease) in cash and cash equivalents                                   | 1,508                   | (2,432)   |
| Cash and cash equivalents, beginning of year   | 1,680                   | 4,112     |
| Cash and cash equivalents, end of year   | \$3,188                 | \$1,680   |
| Supplemental disclosures of cash flow information:                                     |                         |           |

Noncash investing and financing activities:

|  |     |      |
|--|-----|------|
| Capital lease agreement for the acquisition of equipment | \$— | \$22 |
|--|-----|------|

Supplemental disclosures of cash flow information:

|                            |     |     |
|----------------------------|-----|-----|
| Cash paid for income taxes | \$7 | \$9 |
|----------------------------|-----|-----|

|                        |     |     |
|------------------------|-----|-----|
| Cash paid for interest | \$8 | \$— |
|------------------------|-----|-----|

*See notes to consolidated financial statements.*

Table of Contents

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

1. Description of Business

Pro-Dex, Inc. (“Pro-Dex”, the “Company”, “we”, “us” or “our”) specializes in the design and manufacture of powered surgical and dental instruments and multi-axis motion control systems, and serves such markets as medical, research and industrial. Pro-Dex’s products are found in hospitals, dental offices, medical engineering labs, scientific research facilities and high tech manufacturing operations around the world.

2. Summary of Significant Accounting Policies

The summary of significant accounting policies presented below is designed to assist the reader in understanding our consolidated financial statements. Such financial statements and related notes are the representations of management, who is responsible for their integrity and objectivity. In the opinion of management, these accounting policies conform to accounting principles generally accepted in the United States of America (“GAAP”) in all material respects, and have been consistently applied in preparing the accompanying consolidated financial statements.

**Principles of Consolidation**

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, Pro-Dex Astromec, Inc. (Note 3), and Pro-Dex Management, Inc., a non-operating subsidiary. All significant inter-company accounts and transactions have been eliminated.

**Revenue Recognition**

Revenue on product sales is recognized upon shipment to the customer when risk of loss and title transfer to the customer and all other conditions required by GAAP, as promulgated by the Financial Accounting Standards Board (“FASB”) in Accounting Standards Codification (“ASC”) Section 605 (formerly Staff Accounting Bulletin No. 104, *Revenue Recognition*), have been satisfied.

Certain of our contracts are development and supply contracts. Such contracts provide for billable, fixed-price, non-recurring engineering services in addition to product sales, which are considered as multiple deliverables under the provisions of ASC 605. Revenue from the non-recurring engineering service portions of such contracts is generally recognized under the completed contract method. Accordingly, revenue from product development milestone billing to our customers under such contracts is deferred.

Returns of our product for credit are minimal; accordingly, we do not establish a reserve for product returns at the time of sale.

**Estimated Losses on Product Development Services**

Cost and revenue estimates related to the product development service portions of development and supply contracts are reviewed and updated quarterly. When it is probable that total costs from the development portion of such contracts will exceed product development service revenue, the expected loss is recognized immediately in cost of sales. Contract costs include all direct material, labor and those indirect costs related to contract performance.

Owing to the complexity of many of the contracts we have undertaken, the cost estimation process requires significant judgment. It is based upon the knowledge and experience of our project managers, engineers, and finance professionals. Factors that are considered in estimating the cost of work to be completed and ultimate profitability of the fixed price product development portion of development and supply contracts include, among others, the nature and complexity of the work to be performed, availability and productivity of labor, the effect of change orders, the availability of materials, performance of subcontractors, and expected costs for specific regulatory approvals.

### **Warranties**

Certain of our products are sold with a warranty that provides for repairs or replacement of any defective parts for a period, generally one to two years, after the sale. At the time of the sale, we accrue an estimate of the cost of providing the warranty based on prior experience with such factors as return rates and repair costs, which factors are reviewed quarterly.

Table of Contents

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

The warranty accrual is based on historical costs of warranty repairs and expected future identifiable warranty expenses, and is included in accrued expenses in the accompanying consolidated balance sheets. Warranty expenses are included in cost of sales in the accompanying consolidated statements of operations. Changes in estimates to previously established warranty accruals result from current period updates to assumptions regarding repair costs and warranty return rates, and are included in current period warranty expense.

**Comprehensive Income**

Comprehensive income encompasses all changes in equity other than those with shareholders and consists of net income (loss) and unrealized gain (loss) on marketable equity investments.

**Cash and Cash Equivalents**

We consider all highly liquid investments with an original maturity of ninety days or less to be cash equivalents. At June 30, 2014 and 2013, cash equivalents consisted of investments in money market funds.

**Accounts Receivable and Unbilled Receivables**

Trade receivables are stated at their original invoice amounts, less an allowance for doubtful portions of such accounts. Management determines the allowance for doubtful accounts based on facts and circumstances related to specific accounts and on historical experience related to the age of accounts. Trade receivables are written off when deemed uncollectible. Recoveries of trade receivables previously reserved are offset against the allowance when received.

Unbilled receivables reflect revenues from non-recurring engineering services not yet billable to customers under the terms of the related development and supply contracts.

**Inventories**

Inventories are stated at the lower of cost (first-in, first-out method) or market value. Reductions to estimated market value are recorded, and charged to cost of sales, when indicated based on a formula that compares on-hand quantities to estimated demand over the ensuing 12 months from the measurement date.

**Investments**

Investments consist of marketable equity securities of publicly held companies. Management intends to hold such securities for a sufficient period in which to realize a reasonable return, which periods may range between one and several years, although there is no assurance that positive returns will be realized or that such securities will not be liquidated in a shorter-than-expected time frame to accommodate future liquidity requirements. Accordingly, investments have been classified as non-current and available-for-sale in conformity with ASC Section 320. Investments are marked to market at each measurement date, with unrealized gains and losses presented as

adjustments to accumulated other comprehensive income or loss.

**Plant, Equipment and Leasehold Improvements, and Real Estate Held For Sale**

Plant, equipment and leasehold improvements are recorded at historical cost and depreciation is provided using the straight-line method over the following periods:

|                        |  |
|------------------------|--|
| Equipment              | Three to ten years   |
| Leasehold improvements | Shorter of the lease term or the asset's estimated useful life |

As more fully described in Note 3, on February 27, 2012, we completed the sale of our fractional horsepower motor product line, operating under the name Pro-Dex Astromec ("Astromec"), consisting primarily of inventories and equipment. On that date we also reclassified the land and building we then owned, which comprised the facility in which Astromec operated, to real estate held for sale. The carrying value of real estate held for sale was based on its historical cost at the date on which such assets were classified as held for sale (Note 3), and was not subject to depreciation as of that date. Also as described in Note 3, on July 5, 2013, we completed the sale of the land and building.

Table of Contents

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Long-Lived Assets**

We review the recoverability of the carrying amount of long-lived assets, such as equipment and leasehold improvements, and real estate held for sale, when events or changes in circumstances occur that indicate such carrying values may not be recoverable. With respect to equipment and leasehold improvements, carrying values are compared to expected future pre-tax cash flows, undiscounted and without interest charges, of related operations. With respect to real estate held for sale, the carrying value prior to its sale (Note 3) was compared to the then-estimated net proceeds from sale of the real estate. Impairment losses are recognized in instances where carrying values are less than such expected future cash flows or net proceeds from sale, as applicable.

**Income Taxes**

We recognize deferred tax assets and liabilities for temporary differences between the financial reporting basis and the tax basis of our assets and liabilities along with net operating loss and tax credit carryovers. Deferred tax assets at both June 30, 2014 and 2013 consisted primarily of basis differences related to research and development tax credit utilization, intangible assets, accrued expenses and inventories.

Significant management judgment is required in determining the provision for income taxes and the recoverability of deferred tax assets. Such determination is based on historical taxable income, with consideration given to estimates of future taxable income and the periods over which deferred tax assets will be recoverable. We record a valuation allowance against deferred tax assets to reduce the net carrying value to an amount that we believe is more likely than not to be realized. When we establish or reduce the valuation allowance against deferred tax assets, the provision for income taxes will increase or decrease, respectively, in the period such determination is made.

**Shipping and Handling**

Payments from customers for shipping and handling are included in net sales. Shipping expenses, consisting primarily of payments made to freight companies, are included in cost of sales.

**Concentration of Credit Risk**

Financial instruments that potentially subject us to credit risk consist principally of cash and trade receivables. We place our cash with major financial institutions. At June 30, 2014 and 2013, and throughout the fiscal years then ended, we had deposits in excess of federally insured limits. Credit sales are made to original equipment manufacturers and resellers throughout the world, and sales to such customers account for a substantial portion of our trade receivables. While such receivables are not collateralized, we evaluate their collectability based on several factors including customers' payment histories.

**Compensation Plans**

*Share-Based Plans*



We recognize compensation expense for all share-based awards made to employees and directors. The fair value of share-based awards is estimated at the grant date using the Black-Scholes option-pricing model. The portion that is ultimately expected to vest is recognized as compensation cost over the requisite service period using the straight-line single option method.

The determination of fair value using the Black-Scholes model is affected by our stock price as well as assumptions regarding a number of complex and subjective variables, including expected stock price volatility, risk-free interest rate, expected dividends, projected employee stock option exercise behaviors and forfeitures. We estimate stock price volatility based on two factors: (a) the measurement date (typically the grant date) and (b) the expected life of the option, which we calculate using the Staff Accounting Bulletin No. 107 simplified method.

Table of Contents

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*Cash-Based Plans*

Our Annual Incentive Plan (“AIP”) provides annual cash-based incentive opportunities for our key employees based upon the attainment of certain performance goals. Compensation expense is recognized in the year in which awards under the terms of the AIP are earned.

Our Long-Term Incentive Plan (“LTIP”) provides incentive opportunities to our executives and other key employees. LTIP awards, if any, are conditioned on attainment of certain performance goals for one or more fiscal years as ratified by our Board of Directors. The amount of awards are defined in the LTIP as a percentage, ranging from 12.5% to 75%, of the employee’s base compensation at the award date, which amount is then divided by the per share market price of our common stock at the award date in order to determine the number of common shares to be awarded. Accordingly, LTIP awards, although paid in shares of our common stock, are dollar-based and accrued as liabilities when their payment becomes probable.

**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.

Our operations are affected by numerous factors including market acceptance of our products, changes in technologies, and new laws, government regulations and policies. We cannot predict what impact, if any, the occurrence of these or other events might have on our operations. Significant estimates and assumptions made by management include, but are not limited to, revenue recognition, the allowance for doubtful accounts, accrued warranty expense, inventory valuation, the carrying value of long-lived assets, and the recovery of deferred income tax assets.

**Basic and Diluted Per Share Information**

Basic per share amounts are computed on the basis of the weighted-average number of common shares outstanding during each period presented. Diluted per share amounts assume the exercise of all potential common stock equivalents, consisting solely of options to purchase common stock as discussed in Note 9, unless the effect of such exercise is to increase income, or decrease loss, per common share.

**Fair Value Measurements**

Fair value is measured based on the prices that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value measurements are based on a three-tier hierarchy that prioritizes the inputs used to measure fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs for which little or no market data exists, therefore requiring an entity to develop its own assumptions.

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

*Investments:* Investments consist of marketable equity securities of publicly held companies. As such, investments are classified within Level 1 of the valuation hierarchy.

Although the methods above may produce a fair value calculation that may not be indicative of the net realizable value or reflective of future fair values, we believe our valuation methods are appropriate.

### **Research and Development**

Research and development costs support the development of our product line platforms, and are charged to expense as incurred.

Table of Contents

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Advertising**

Advertising costs are charged to selling expense as incurred and amounted to \$61,000 and \$139,000 for the fiscal years ended June 30, 2014 and 2013, respectively.

**Recent Accounting Standards**

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, "Revenue from Contracts with Customers," which outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. ASU 2014-09 requires an entity to recognize revenue depicting the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 will also result in enhanced revenue related disclosures. ASU 2014-09 is effective for fiscal years, and interim reporting periods within those years, beginning after December 15, 2016. The Company has not yet determined the impact of ASU 2014-09 on its consolidated results of operations, financial condition, or cash flows.

In April 2014, the FASB issued ASU 2014-08, "Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity." ASU 2014-08 requires that a disposal representing a strategic shift that has (or will have) a major effect on an entity's financial results or a business activity classified as held for sale should be reported as discontinued operations. ASU 2014-08 also expands the disclosure requirements for discontinued operations and adds new disclosures for individually significant dispositions that do not qualify as discontinued operations. ASU 2014-08 is effective prospectively for fiscal years, and interim reporting periods within those years, beginning after December 15, 2014. The impact of ASU 2014-08 is dependent upon the nature of dispositions, if any, after adoption.

**Reclassifications**

Certain prior period balances have been reclassified to conform to the current period presentation.

**3. Discontinued Operations and Real Estate Held for Sale**

In February 2012, we completed the sale of our fractional horsepower motor product line located in Carson City, Nevada, operating under the name Pro-Dex Astromec ("Astromec") to SL Montevideo Technology, Inc. ("MTI"), a wholly owned subsidiary of SL Industries, Inc., pursuant to an Asset Purchase Agreement (the "APA").

Under the terms of the APA, we sold substantially all the assets of Astromec, consisting primarily of inventory, equipment and intangibles, and excluding cash, accounts receivable and the Carson City facility. We retained substantially all of Astromec's liabilities except for those liabilities associated with certain contracts and unfilled purchase orders assumed by MTI.

Under the terms of the APA, we also receive earnout payments based on revenues generated from the sale of (i) Astromec products and (ii) MTI products to Astromec prospects (defined in the APA) (collectively, the “Earnout Sales Base”). Such earnout payments, if and when earned, are paid by MTI to us within 30 days following the end of each of our fiscal quarters during the three years subsequent to the Closing Date, and amount to 6%, 4% and 2% of the Earnout Sales Base in the first, second and third such years, respectively. The earnout payments are recognized in the quarter in which we become entitled to receive them. For the years ended June 30, 2014 and 2013, we recognized income from earnout payments of \$120,000 and \$166,000, respectively, of which \$17,000 and \$31,000 was included in trade receivables in the accompanying June 30, 2014 and 2013 balance sheets, respectively, and were received in July 2014 and 2013, respectively.

In addition, as a result of the sale of the Astromec product line, we listed for sale the land and building constituting the facility in Carson City, Nevada, which was presented as real estate held for sale in the June 30, 2013 consolidated balance sheet with an aggregate carrying amount of \$733,000. On April 22, 2013, we entered into a Purchase Agreement with Aesthetic and Reconstructive Technologies, Inc., a Nevada corporation, whereby we agreed to sell the Carson City facility described above. On July 5, 2013, we completed the sale and closed the Purchase Agreement in conformity with its terms. The sales price of the property was \$980,000, of which we received net proceeds of \$900,000, after deductions for expenses related to the sale, primarily consisting of broker commissions and fees, aggregating approximately \$80,000, resulting in a gain of \$167,000.

Table of Contents**PRO-DEX, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Based on the foregoing, and in conformity with applicable accounting guidance, the Astromec product line qualifies as a discontinued operation. Accordingly, financial results of Astromec have been reported as discontinued operations in the accompanying consolidated statements of operations for all periods presented. Information regarding revenue and operating results of Astromec included in discontinued operations is as follows (in thousands):

|  | Years Ended<br>June 30, |       |
|--|-------------------------|-------|
|  | 2014                    | 2013  |
| Revenues   | \$120                   | \$166 |
| Income before provision for income taxes of \$107,000 and \$51,000, respectively | \$270                   | \$131 |

Information regarding Astromec assets and liabilities included in the accompanying consolidated balance sheets is as follows (in thousands):

|                     | June 30, |      |
|---------------------|----------|------|
|                     | 2014     | 2013 |
| Accounts receivable | \$17     | \$31 |
| Prepaid expenses    | \$3      | \$—  |
| Accrued expenses    | \$2      | \$5  |

**4. Composition of Certain Financial Statement Items****Inventory**

Inventory is stated at the lower of cost (first-in, first-out) or market and consists of the following (in thousands):

|                                     | June 30, |         |
|-------------------------------------|----------|---------|
|                                     | 2014     | 2013    |
| Raw materials /purchased components | \$878    | \$1,640 |
| Work in process                     | 525      | 572     |
| Sub-assemblies /finished components | 823      | 1,291   |
| Finished goods                      | 374      | 331     |
| Total inventory                     | \$2,600  | \$3,834 |

**Investments**

Investments are stated at market value and consist of the following (in thousands):

|  | June 30, |      |
|--|----------|------|
|  | 2014     | 2013 |

Marketable equity securities    \$1,058    \$370

Investments at June 30, 2014 and June 30, 2013 had an aggregate cost basis of \$857,000 and \$365,000, respectively, gross unrealized gains aggregating \$209,000 and \$5,000, respectively, and unrealized losses of \$7,000 and \$0, respectively. During the fiscal year ended June 30, 2014, we sold certain of our investments in marketable equity securities of publicly held companies and recorded realized gains of \$65,000. There were no sales of investments during fiscal 2013.

Table of Contents**PRO-DEX, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Equipment and Leasehold Improvements**

Equipment and leasehold improvements consist of the following (in thousands):

|   | June 30, |         |
|---|----------|---------|
|   | 2014     | 2013    |
| Office furnishings and fixtures                 | \$2,054  | \$2,207 |
| Machinery and equipment                         | 4,574    | 4,626   |
| Leasehold improvements                          | 2,312    | 2,312   |
| Total   | 8,940    | 9,145   |
| Less: Accumulated depreciation and amortization | (7,365)  | (7,080) |
|   | \$1,575  | \$2,065 |

Depreciation expense, which includes capital lease amortization, for the years ended June 30, 2014 and 2013 amounted to \$527,000 and \$582,000, respectively.

**Accrued Liabilities**

Accrued liabilities consist of the following (in thousands):

|   | June 30, |         |
|---|----------|---------|
|   | 2014     | 2013    |
| Warranty                                | \$237    | \$323   |
| Payroll and related items               | 240      | 243     |
| Accrued losses on development contracts | 468      | 176     |
| Termination benefits                    | —        | 165     |
| Accrued inventory in transit            | 22       | 142     |
| Other                                   | 123      | 227     |
|   | \$1,090  | \$1,276 |

**Accumulated Other Comprehensive Income**

Accumulated other comprehensive income consists of the following (in thousands):

|  | June 30, |      |
|--|----------|------|
|  | 2014     | 2013 |
| Unrealized gain on marketable equity securities      | \$262    | \$ 5 |
| Less: Reclassification of gains included in net loss | (65)     | —    |
| Unrealized gain on marketable securities, net        | \$197    | \$ 5 |



## **Intangibles**

Intangibles at June 30, 2014 consist of approximately \$68,000 in legal fees incurred in connection with patent applications, and will be amortized over the life of the applicable patent upon its issuance as well as approximately \$37,000 of capitalized software costs relating to internally developed software which will be amortized over the estimated product life of the underlying product currently in development.

## **5. Bank Debt**

In September 2012, we terminated a bank credit facility and, in connection with such termination, repaid the entire principal balance of a term loan, amounting to \$685,000.

As a result of the foregoing, we no longer have a credit facility with a financial institution.

Table of Contents**PRO-DEX, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****6. Warranty Accrual**

Information relating to the accrual for warranty costs for the years ended June 30, 2014 and 2013 is as follows (in thousands):

|  | June 30, |       |
|--|----------|-------|
|  | 2014     | 2013  |
| Balance at beginning of year                 | \$323    | \$526 |
| Accruals during the year                     | 225      | 346   |
| Change in estimates of prior period accruals | (108)    | (51)  |
| Warranty amortization                        | (203)    | (498) |
| Balance at end of year                       | \$237    | \$323 |

Warranty expense was \$117,000 and \$295,000 for the fiscal years ended June 30, 2014 and 2013.

**7. Income Taxes**

The provision for (benefit from) income taxes from continuing operations consists of the following amounts (in thousands):

|                           | Years Ended<br>June 30, |        |
|---------------------------|-------------------------|--------|
|                           | 2014                    | 2013   |
| Current:                  |                         |        |
| Federal                   | \$—                     | \$5    |
| State                     | 3                       | 7      |
| Deferred:                 |                         |        |
| Federal                   | (84)                    | (41)   |
| State                     | (23)                    | (10)   |
| Benefit from income taxes | \$(104)                 | \$(39) |

The effective income tax rate on loss from continuing operations differs from the United States statutory income tax rates for the reasons set forth in the table below (in thousands, except percentages).

|   | Years Ended June 30, |         |           |         |
|---|----------------------|---------|-----------|---------|
|   | 2014                 |         | 2013      |         |
|   | Amount               | Percent | Amount    | Percent |
|   | Income               | Pretax  | Income    | Pretax  |
| Loss from continuing operations before income taxes | \$(755)              | 100%    | \$(1,903) | 100%    |

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|   |       |        |        |        |
|---|-------|--------|--------|--------|
| Computed “expected” income tax benefit on loss from continuing operations before income taxes | \$257 | 34%    | \$647  | 34%    |
| State tax, net of federal benefit   | (10 ) | (1% )  | 130    | 7%     |
| Tax incentives  | 30    | 4%     | 129    | 7%     |
| Change in valuation allowance   | (154) | (21% ) | (851 ) | (45% ) |
| Permanent differences   | (31 ) | (4% )  | (29 )  | (2% )  |
| State income tax rate adjustment  | 12    | 2%     | 13     | 1%     |
| Income tax benefit  | \$104 | 14%    | \$39   | 2%     |

The total income tax expense recorded for the years ended June 30, 2014 and 2013 was as follows (in thousands):

35

Table of Contents**PRO-DEX, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

|  | June 30, |        |
|--|----------|--------|
|  | 2014     | 2013   |
| Tax benefit from continuing operations   | \$(104)  | \$(39) |
| Tax expense from discontinued operations | 107      | 51     |
|  | \$3      | \$12   |

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and liabilities at June 30, 2014 and 2013 are as follows (in thousands):

|  | June 30, |       |
|--|----------|-------|
|  | 2014     | 2013  |
| Deferred tax assets/(liabilities) – current: |          |       |
| Accrued expenses                             | \$253    | \$206 |
| Inventory                                    | 486      | 504   |
| Net operating losses                         | 119      | —     |
| State taxes                                  | 1        | 2     |
| Less: valuation allowance                    | (744)    | (653) |
| Net deferred tax assets                      | \$115    | \$59  |

|   | June 30, |         |
|---|----------|---------|
|   | 2014     | 2013    |
| Deferred tax assets/(liabilities) – non-current:                          |          |         |
| Income tax credit carry forwards  | \$1,443  | \$1,381 |
| Net operating losses  | 1,299    | 1,092   |
| Intangible assets   | 287      | 350     |
| Deferred rent   | 132      | 149     |
| State taxes   | 16       | 16      |
| Property and equipment, principally due to differing depreciation methods | (458 )   | (291 )  |
| Share based compensation  | 16       | 32      |
| Unrealized gain on investment   | (85 )    | (2 )    |
| Total gross deferred tax assets   | 2,650    | 2,727   |
| Less: valuation allowance   | (2,765)  | (2,786) |
| Net deferred tax liabilities  | \$(115 ) | \$(59 ) |

We have federal net operating loss carry forwards at June 30, 2014 and 2013 in the amount of \$2,556,000 and \$1,701,000, respectively, which begin to expire in 2034. State net operating loss carry forwards at June 30, 2014 and 2013 amount to \$6,339,000 and \$6,134,000, respectively, and begin to expire in 2025. Federal tax credit carry forwards at June 30, 2014 and 2013 amount to \$884,000 and \$867,000, respectively, and begin to expire in 2027. State tax credit carry forwards at June 30, 2014 and 2013 amount to \$559,000 and \$514,000, respectively, the majority of which do not expire.

Significant management judgment is required in determining our provision for income taxes and the recoverability of our deferred tax asset. Such determination is based primarily on our historical taxable income, with some consideration given to our estimates of future taxable income by jurisdictions in which we operate and the period over which our deferred tax assets will be recoverable. Due to cumulative taxable losses in recent years, we have maintained a full valuation allowance against our deferred tax assets at June 30, 2014 and 2013, information related to which is as follows (in thousands):

36

Table of Contents**PRO-DEX, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

|  | <b>Valuation<br/>Allowance</b> |
|--|--------------------------------|
| Balance at July 1, 2013                            | \$(3,439 )                     |
| Increase in deferred tax asset valuation allowance | (70 )                          |
| Balance at January 31, 2014                        | \$(3,509 )                     |

As of June 30, 2014, we have accrued \$363,000 of unrecognized tax benefits related to federal and state income tax matters. The amount that would reduce the Company's income tax expense if recognized and result in a corresponding decrease in the Company's effective tax rate is \$47,000.

Information with respect to our accrual for unrecognized tax benefits is as follows (in thousands):

|  |        |
|--|--------|
| Balance at July 1, 2013                                      | \$ 347 |
| Additions based on tax positions related to the current year | 21     |
| Reductions for tax positions of prior years                  | (5 )   |
| Balance at June 30, 2014                                     | \$ 363 |

We recognize accrued interest and penalties related to unrecognized tax benefits in income tax expense when applicable. As of June 30, 2014, no interest or penalties applicable to our unrecognized tax benefits have been accrued since we have sufficient tax attributes available to fully offset any potential assessment of additional tax.

We are subject to U.S. federal income tax, as well as income tax of multiple state tax jurisdictions. We are currently open to audit under the statute of limitations by the Internal Revenue Service for the years ended June 30, 2011 and later. Our state income tax returns are open to audit under the statute of limitations for the years ended June 30, 2010 and later. We do not anticipate a significant change to the total amount of unrecognized tax benefits within the next 12 months.

**8. Commitments and Contingencies****Leases**

We lease our office, production and warehouse facilities in Irvine, California and Beaverton, Oregon under agreements that expire in April 2018 and July 2017, respectively. Both leases require us to pay insurance, taxes, and other expenses related to the leased space. Rent expense in 2014 and 2013 was \$518,000 and \$592,000, respectively. On December 13, 2013, we entered into a first amendment with respect to our Beaverton, Oregon lease which extended the lease termination from April 30, 2014 to July 31, 2017, reduced the occupied square footage, reduced the corresponding monthly base rent by \$1,352 and provided for one month of rent abatement over each of the next three

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years of the extended lease term. On July 15, 2013, we entered into an amendment with respect to our Irvine, California lease which provides for a \$4,227 reduction in the monthly base rent (as compared to the monthly base rent that would have been payable under the original lease terms) beginning on July 1, 2013 and continuing for the remainder of the term of the lease. Minimum lease payments for future fiscal years ending June 30 are as follows (in thousands):

| Fiscal Year:                 | Operating<br>Leases |
|------------------------------|---------------------|
| 2015                         | \$ 488              |
| 2016                         | 504                 |
| 2017                         | 527                 |
| 2018                         | 361                 |
| Total minimum lease payments | \$ 1,880            |

Table of Contents

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Compensation Arrangements**

Retirement Savings 401(k) Plan

The Pro-Dex, Inc. Retirement Savings 401(k) Plan (the “401(k) Plan”) is a defined contribution plan we administer that covers substantially all our employees and is subject to the provisions of the Employee Retirement Income Security Act of 1974, as amended. Employees are eligible to participate in the 401(k) Plan when they have attained 19 years of age and then can enter into the 401(k) Plan on the first day of each calendar quarter. Participants are eligible to receive non-discretionary Pro-Dex matching contributions of 25% of their contributions up to 5% of eligible compensation, once they have completed six months of service. For the years ended June 30, 2014 and 2013, we recognized compensation expense amounting to \$31,000 and \$41,000, respectively, in connection with the 401(k) Plan.

Annual Incentive Plan (“AIP”)

The AIP provides annual incentive opportunities for our key employees based upon the attainment of certain performance goals. Compensation expense under the terms of the AIP amounted to \$29,000 in fiscal year 2012. No compensation expense was accrued under the terms of the AIP in either fiscal year 2014 or 2013, however a reversal of approximately \$9,000 of previously accrued compensation expense was recorded in fiscal 2014 due to the separation from employment with us of one of the fiscal 2012 AIP participants whose separation released us from payment under the terms of the AIP. Accrued AIP awards included in accrued liabilities in the accompanying consolidated balance sheets as of June 30, 2014 and 2013 were \$20,000 and \$29,000, respectively.

In September 2013, our Board approved an AIP that provides sets of incentives to achieve performance goals on an annual and a multi-year basis.

Long-Term Incentive Plan (“LTIP”)

The LTIP provides incentive opportunities to our executives and other key employees, and are conditioned on attainment of certain performance goals for one or more fiscal years. Awards under the LTIP are accrued when payment of such awards becomes probable. For the years ended June 30, 2014 and 2013, compensation expense reductions under the terms of the LTIP amounted to \$4,000 and \$52,000, respectively. Accrued LTIP awards related to the fiscal 2012 – 2015 award period included in accrued liabilities in the accompanying consolidated balance sheets as of June 30, 2014 and 2013 were \$6,000 and \$10,000, respectively.

Concurrent with our Board’s approval in September 2013 of an AIP that provides incentives over a multi-year basis of achievement as described above, the LTIP was discontinued for years subsequent to the fiscal 2012 – 2015 award period.

Change of Control Agreements



Through July 2014, we were party to Change of Control Agreements (the “CIC Agreements”) with members of senior management, including our former Chief Executive Officer, Michael J. Berthelot, our current Chief Executive Officer and Chief Financial Officer, Harold A. Hurwitz, and our Chief Operating Officer, Richard L. Van Kirk. The CIC agreements provided for awards to be paid to individuals whose employment with us involuntarily terminated (as such term is defined in the CIC Agreements) within 12 months after a change of control.

As a result of a contested election of directors in fiscal year 2013, our shareholders, at our January 17, 2013 Annual Meeting of Shareholders, elected four new directors and one then-incumbent director to fill the five seats on our Board. This degree of change in the composition of our Board of Directors constituted a “change of control” as defined in the CIC Agreements. On February 25, 2013, Mr. Berthelot, then our Chief Executive Officer, was separated from the Company. In connection with the separation, Mr. Berthelot was paid, among other items, \$165,423 as contemplated by his CIC Agreement. In addition, on June 19, 2013, we effected a reduction in force that included one additional member of senior management, resulting in a \$97,000 benefit to such individual as contemplated by this individual’s CIC Agreement, which was included in accrued expenses as of June 30, 2013 and paid in July 2013.

Table of Contents**PRO-DEX, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

After giving effect to our payments to Mr. Berthelot and the additional member of senior management under their respective CIC Agreements as described above, we had remaining CIC Agreements with Messrs. Hurwitz and Van Kirk that expired in July 2014 in conformity with their CIC Agreements' terms.

**Legal Matters**

We are from time to time a party to various legal proceedings incidental to our business, none of which we consider may be material. There can be no certainty, however, that we may not ultimately incur liability or that such liability will not be material and adverse.

**9.Share-Based Compensation****Stock Option Plans**

Through June 2014, we had two active stock option plans, the Second Amended and Restated 2004 Stock Option Plan (the "Employees Stock Option Plan") and the Amended and Restated 2004 Directors Stock Option Plan (the "Directors Stock Option Plan" and, collectively with the Employees Stock Option Plan, the "Option Plans"), pursuant to which (i) options to purchase shares of common stock, or (ii) restricted shares of common stock, could be granted up to an aggregate amount of 1,333,333 common shares, with 1,066,667 and 266,666 shares distributed between the Employees Stock Option Plan and the Directors Stock Option Plan, respectively. The Option Plans were substantially similar, providing for a strike price equal to the closing price for a share of our common stock as of the last business day immediately prior to the Grant Date, vesting periods, as determined by the Board of Directors for the Employees Stock Option Plan and six months for the Directors Stock Option Plan, and terms of up to ten years, subject to forfeit 30 days after the holder ceases to be an employee or 90 days after the holder ceases to be director, as the case may be. At June 30, 2014, options to purchase an aggregate of 531,381 and 173,334 shares under the Employees Stock Option Plan and the Directors Stock Option Plan, respectively, were available to grant in future years. Aggregate share-based compensation expense under the Plans for the years ended June 30, 2014 and 2013 were \$50,000 and \$100,000, respectively.

There were no stock options granted during the fiscal year ended June 30, 2014. The following weighted average assumptions were used in the calculation of share-based compensation expense for options granted during the year ended June 30, 2013:

|  | Year Ended<br>June 30, 2013 |
|--|-----------------------------|
| Weighted average risk-free interest rate | 0.9%                        |
| Expected life (in years)                 | 5.7                         |
| Expected stock price volatility          | 89%                         |

Dividend yield

None

As of June 30, 2014, there was an aggregate of \$11,000 of unrecognized compensation cost under the Option Plans related to 19,167 non-vested outstanding stock options with a per share weighted average value of \$1.56. The unrecognized expense is anticipated to be recognized on a straight-line basis over a weighted average period of 10 months.

39

Table of Contents**PRO-DEX, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

The following is a summary of stock option activity under the Option Plans for the years ended June 30, 2014 and 2013:

|  | Outstanding Options |                                 |
|--|---------------------|---------------------------------|
|  | Number of Shares    | Weighted-Average Exercise Price |
| Balance, July 1, 2012                      | 591,672             | \$2.48                          |
| Options granted                            | 70,000              | 1.92                            |
| Options canceled or expired                | (325,834)           | ) 2.61                          |
| Options exercised                          | (43,334)            | ) 1.53                          |
| Balance, July 1, 2013                      | 292,504             | \$2.35                          |
| Options granted                            | —                   | —                               |
| Options canceled or expired                | (123,398)           | ) 2.22                          |
| Options exercised                          | (4,104)             | ) 2.33                          |
| Balance, June 30, 2014                     | 165,002             | \$2.40                          |
| Stock Options Exercisable at June 30, 2014 | 145,835             | \$2.49                          |

The following table summarizes information regarding options outstanding and options exercisable under the Option Plans at June 30, 2014:

| Range of Exercise Prices | Options Outstanding |  |                              |                            | Options Exercisable |  |                              |                         |
|--------------------------|---------------------|--|------------------------------|----------------------------|---------------------|--|------------------------------|-------------------------|
|                          | Number Outstanding  | Weighted-Avg. Remaining Contractual Life | Weighted-Avg. Exercise Price | Aggregate. Intrinsic Value | Number Outstanding  | Weighted-Avg. Remaining Contractual Life | Weighted-Avg. Exercise Price | Average Intrinsic Value |
| \$0 to 2.50              | 145,500             | 7.23                                     | \$1.87                       | \$33,600                   | 125,833             | 7.13                                     | \$1.89                       | \$26,917                |
| 2.5 to 5.00              | 3,334               | 2.88                                     | 4.38                         | —                          | 3,334               | 2.88                                     | 4.38                         | —                       |
| 5.01 to 7.50             | 8,334               | 0.02                                     | 5.58                         | —                          | 8,334               | 0.02                                     | 5.58                         | —                       |
| 7.51 to 10.00            | 8,334               | 1.52                                     | 7.65                         | —                          | 8,334               | 1.52                                     | 7.65                         | —                       |
| Total                    | 165,002             | 6.49 years                               | \$2.40                       | \$33,600                   | 145,835             | 6.31                                     | \$2.49                       | \$26,917                |

In June 2014, our Board of Directors terminated the Employees Stock Option Plan, with the provision that options outstanding under the Employees Stock Option Plan will remain outstanding in accordance with their respective terms. In September 2014, our Board approved the inclusion in our proxy statement for approval by our shareholders at the 2014 Annual Meeting of Shareholders its recommendation to terminate the Directors Stock Option Plan.

**Employee Stock Purchase Plan**

Also in September 2014, our Board approved the establishment of an Employee Stock Purchase Plan (the “ESPP”). The ESPP conforms to the provisions of Section 423 of the Internal Revenue Code, has coterminous offering and purchase

periods of six months, and bases the pricing to purchase shares of our common stock on a formula so as to result in a per share purchase price that approximates a 15% discount from the market price of a share of our common stock at the end of the purchase period. The Board of Directors also approved the provision that shares formerly reserved for issuance under the Employee Stock Option Plan in excess of shares issuable pursuant to outstanding options be reserved for issuance pursuant to the ESPP.

Table of Contents**PRO-DEX, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Restricted Stock**

The following is a summary of restricted share activity for the years ended June 30, 2014 and 2013:

|                        | Outstanding Restricted Stock Units |                              |
|------------------------|------------------------------------|------------------------------|
|                        | Number                             | Weighted-Average Stock Price |
|                        | of Shares                          | On Grant Date                |
| Balance, June 30, 2012 | —                                  | \$—                          |
| Granted                | 35,000                             | 1.73                         |
| Forfeited              | (2,500 )                           | 1.73                         |
| Vested                 | —                                  | —                            |
| Balance, June 30, 2013 | 32,500                             | \$1.73                       |
| Granted                | —                                  | —                            |
| Forfeited              | (10,001 )                          | 1.73                         |
| Vested                 | (9,166 )                           | 1.73                         |
| Balance, June 30, 2014 | 13,333                             | \$1.73                       |

As of June 30, 2014, there was \$10,000 in unrecognized compensation cost related to non-vested outstanding restricted shares. The unrecognized expense is anticipated to be amortized over the next 1.2 years.

**10. Major Customers**

The customer providing 10 percent or more of our revenue for either of the years ended June 30, 2014 and 2013 is listed below (in thousands, except percentages).

|                         | Years Ended June 31, |               |
|-------------------------|----------------------|---------------|
|                         | 2014                 | 2013          |
| Total revenue           | \$10,812 100%        | \$12,249 100% |
| Customer concentration: |                      |               |
| Customer 1              | \$ 5,318 49%         | \$ 5,809 47%  |

The customer comprising 10 percent or more of our gross accounts receivable at either June 30, 2014 or 2013 is listed below (in thousands, except percentages).

|                                 | June 30,     |              |
|---------------------------------|--------------|--------------|
|                                 | 2014         | 2013         |
| Total gross accounts receivable | \$1,805 100% | \$1,355 100% |

Customer concentration:

|            |        |     |        |     |
|------------|--------|-----|--------|-----|
| Customer 1 | \$ 962 | 53% | \$ 417 | 31% |
|------------|--------|-----|--------|-----|

11. Loss Per Share

We calculate basic loss per share by dividing net loss by the weighted average number of common shares outstanding during the reporting period. Diluted loss per share reflects the effects of potentially dilutive securities. Because we incurred net losses for the fiscal years ended June 30, 2014 and 2013, basic and diluted loss per share were the same as the inclusion common shares, amounting to 23,519 and 11,999 as of June 30, 2014 and 2013, respective, potentially issuable under the terms of outstanding stock option grants would have had an antidilutive effect. The summary of the basic and diluted earnings per share calculations for the years ended June 30, 2014 and 2013 is as follows (in thousands, except per share data):

41

Table of Contents**PRO-DEX, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

|   | Years Ended June<br>30, |           |
|---|-------------------------|-----------|
|   | 2014                    | 2013      |
| Basic & Diluted:  |                         |           |
| Loss from continuing operations                                 | \$(651 )                | \$(1,864) |
| Weighted average shares outstanding                             | 3,493                   | 3,322     |
| Basic and diluted loss per share from continuing operations     | \$(0.19 )               | \$(0.56 ) |
| Income from discontinued operations                             | \$163                   | \$80      |
| Weighted average shares outstanding                             | 3,493                   | 3,322     |
| Basic and diluted income per share from discontinued operations | \$0.05                  | \$0.02    |
| Net loss  | \$(488 )                | \$(1,784) |
| Weighted average shares outstanding                             | 3,493                   | 3,322     |
| Basic and diluted loss per share                                | \$(0.14 )               | \$(0.54 ) |

**12. Common Stock****Rights Offering**

We commenced a common stock rights offering on March 24, 2014, pursuant to a registration statement on Form S-3 filed with the Securities and Exchange Commission (“SEC”). The rights offering was made through the distribution to our existing shareholders as of March 20, 2014 of non-transferable subscription rights to purchase their pro rata portion of newly issued shares of our Common Stock (the “Subscription Privilege”) at a price of \$1.90 per share (the “Subscription Price”). The subscription period for exercise of the rights commenced on March 24, 2014 and expired on April 25, 2014.

Upon completion of the rights offering, we received gross proceeds of approximately \$1.65 million, before estimated expenses of \$140,000, through shareholder subscriptions for 868,732 shares of common stock.

Of the total amount of shares issued, 317,231 and 156,189 shares were issued to AO Partners I, LP (“AO Partners”) and Farnam Street Partners, L.P. (“Farnam Street Partners”), respectively, the Company’s two largest shareholders, who each exercised its full pro-rata allotment of rights in the offering. AO Partners, LLC is the General Partner of AO Partners, and Nicholas J. Swenson, a director of the Company, is the Managing Member of AO Partners. Raymond E. Cabillot, also a director of the Company, is the CEO of Farnam Street Partners.



In connection with the rights offering, we entered into a Standby Purchase Agreement (the “Standby Purchase Agreement”) with AO Partners, LLC and Farnam Street Capital, Inc. (each a beneficial shareholder of our common stock; each a “Standby Purchaser” and collectively the “Standby Purchasers”) pursuant to which the Standby Purchasers agreed to purchase, at the Subscription Price, any and all shares of Common Stock not subscribed for by shareholders in connection with the rights offering, subject to reduction by us as described below. Messrs. Swenson and Cabillot have the power to direct the affairs of AO Partners, LLC and Farnam Street Capital, Inc., respectively. No fees or other consideration were paid by us to the Standby Purchasers in exchange for their commitment to purchase any and all unsubscribed shares of Common Stock following the rights offering.

In the event that the exercise by a shareholder of the Subscription Privilege or the purchase of our common stock under the Standby Purchase Agreement could, in our sole discretion, have potentially resulted in a limitation of our ability to utilize our tax attributes, such as the annual utilization of net operating loss or tax credit carry forwards, we had the ability to reduce the exercise by such shareholder of the Subscription Privilege or the amount purchased under the Standby Purchase Agreement to such number of shares of our Common Stock as we determined advisable in order to preserve our ability to utilize such tax attributes. On the basis of the Company’s analysis of tax attributes, the Company did not reduce the subscriptions of any shareholder in the rights offering, but did reduce to zero the number of shares the Standby Purchasers could have otherwise purchased pursuant to the Standby Purchase Agreement. As a result, no shares were issued to AO Partners, LLC or Farnam Street Capital, Inc. pursuant to the Standby Purchase Agreement.

Table of Contents

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

We intend to use the net proceeds of the rights offering to pursue strategic opportunities that may present themselves from time to time or, if not used to pursue strategic opportunities, for working capital and general corporate purposes, including to fund ongoing research and development and product initiatives. Also, to the extent the net proceeds are not deployed, some of the funds may be invested in accordance with the terms of our Surplus Capital Investment Policy.

**Share Repurchase Program**

In September 2013, our Board approved a share repurchase program authorizing the Company, at the direction of the Investment Committee of the Board, to repurchase up to 750,000 shares of our common stock under parameters to be determined by the Investment Committee. The repurchase program has no stated expiration date and there have been no purchases under the program.

**13. Subsequent Events**

On July 2, 2014, we made an initial deposit in the amount of \$10,000 to open an escrow account to facilitate the purchase of substantially all of the assets of a Northern California-based sole proprietorship that is engaged in the manufacture of machined parts, primarily for customers in the oil and electronics industries. The initial deposit was made pursuant to an Asset Purchase Agreement between the parties dated June 23, 2014 (the "Agreement"), which Agreement became effective upon the Company making the initial deposit. On September 8, 2014, we made a second \$10,000 deposit in conformity with amended terms of the Agreement which acknowledged that certain due diligence procedures had yet to be completed. The deposits, less escrow costs, are refundable to the Company if the transaction is not consummated due to a failure of certain closing conditions, including certain due diligence procedures, to be satisfied.

Table of Contents

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Our Chief Executive Officer and Chief Financial Officer (our principal executive officer and principal financial officer) has concluded, based on his evaluation as of June 30, 2014, that 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”)) are effective at a reasonable assurance level to ensure that information required to be disclosed by us in the reports filed or submitted by us under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms, including to ensure that information required to be disclosed by us in the reports we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

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, 2014.

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 rules of the SEC that apply to smaller reporting companies that permit us to provide only management’s attestation in this annual report.

During the quarter ended June 30, 2014, there were no changes in the Company’s internal controls over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act) that have materially affected, or are

reasonably likely to materially affect, the Company's internal controls over financial reporting.

ITEM 9B. OTHER INFORMATION

None.

44

Table of Contents

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this Item is incorporated herein by reference to our definitive Proxy Statement, which will be filed within 120 days of June 30, 2014, and delivered to stockholders in connection with our 2014 annual meeting of shareholders.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item is incorporated herein by reference to our definitive Proxy Statement, which will be filed within 120 days of June 30, 2014, and delivered to stockholders in connection with our 2014 annual meeting of shareholders.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this Item is incorporated herein by reference to our definitive Proxy Statement, which will be filed within 120 days of June 30, 2014, and delivered to stockholders in connection with our 2014 annual meeting of shareholders.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this Item is incorporated herein by reference to our definitive Proxy Statement, which will be filed within 120 days of June 30, 2014, and delivered to stockholders in connection with our 2014 annual meeting of shareholders.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required by this Item is incorporated herein by reference to our definitive Proxy Statement, which will be filed within 120 days of June 30, 2014, and delivered to stockholders in connection with our 2014 annual meeting of shareholders.

Table of Contents

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

**(a)(3) Exhibits**

Reference is made to the Exhibit Index beginning on page 48 of this report.

Table of Contents

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on September 16, 2014.

PRO-DEX, INC.

/s/ Harold A. Hurwitz  
 Harold A. Hurwitz  
 President and Chief Executive Officer and Director

**POWER OF ATTORNEY**

We, the undersigned directors and officers of Pro-Dex, Inc., do hereby constitute and appoint Harold A. Hurwitz, as our true and lawful attorney-in-fact and agent with power of substitution, to do any and all acts and things in our name and behalf in our capacities as directors and officers and to execute any and all instruments for us and in our names in the capacities indicated below, which such attorney-in-fact and agent may deem necessary or advisable to enable said corporation to comply with the Securities Exchange Act of 1934, as amended, and any rules, regulations and requirements of the Securities and Exchange Commission, in connection with this Annual Report on Form 10-K, including specifically but without limitation, power and authority to sign for us or any of us in our names in the capacities indicated below, any and all amendments hereto; and we do hereby ratify and confirm all that said attorney-in-fact and agent, shall do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| <b>Signature</b>               | <b>Title</b>   | <b>Date</b>           |
|--------------------------------|--|-----------------------|
| /s/ Harold A.<br>Hurwitz       | President, Chief Executive Officer, Treasurer, Chief Financial Officer, Secretary and Director (Principal Executive Officer, and Principal Financial and Accounting Officer) | September 16,<br>2014 |
| <b>Harold A.<br/>Hurwitz</b>   |  |                       |
| /s/ Nicholas J.<br>Swenson     | Chairman of the Board, Director  | September 16,<br>2014 |
| <b>Nicholas J.<br/>Swenson</b> |  |                       |
| /s/ Raymond E.<br>Cabillot     | Director   | September 18,<br>2014 |

**Raymond E.  
Cabillot**

/s/ William J.  
Farrell III

Director

September 16,  
2014

**William J.  
Farrell III**

/s/ David C.  
Hovda

Director

September 17,  
2014

**David C.  
Hovda**

47



Table of Contents

**INDEX TO EXHIBITS**

| <b>Exhibit<br/>No.</b> | <b>Description</b>  |
|------------------------|---|
| 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                    | Articles of Amendment to Articles of Incorporation (incorporated herein by reference to Exhibit 3.1 to the Company's Form 8-K filed December 5, 2007).  |
| 3.3                    | Articles of Amendment to Articles of Incorporation (incorporated herein by reference to Exhibit 3.1 to the Company's Form 8-K filed June 18, 2010).   |
| 3.4                    | Amended and Restated Bylaws, dated January 31, 2011 (incorporated herein by reference to Exhibit 3.1 to the Company's Form 8-K filed February 4, 2011)  |
| 10.1*                  | Second Amended and Restated 2004 Stock Option Plan (incorporated herein by reference to Exhibit 4.1 to the Company's Form S-8 filed February 15, 2012).                                       |
| 10.2*                  | Amended and Restated 2004 Directors Stock Option Plan (incorporated herein by reference to Exhibit 4.2 to the Company's Form S-8 filed February 15, 2012).                                    |
| 10.3*                  | Form of Indemnification Agreement for directors and certain officers (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed October 29, 2008).                     |
| 10.4                   | Lease agreement with Irvine Business Properties, dated August 3, 2007 (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed August 23, 2007).                     |
| 10.5*                  | Long-Term Incentive Plan (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed July 16, 2010).  |
| 10.6*                  | Annual Incentive Plan for the Senior Management (incorporated herein by reference to Exhibit 10.2 to the Company's Form 8-K filed July 16, 2010).   |
| 10.7*                  | Description of Non-Employee Director Compensation Program (incorporated herein by reference to Exhibit 10.3 to the Company's Form 8-K filed July 16, 2010).                                   |
| 10.8*                  | Separation Agreement between Pro-Dex, Inc. and Jeffrey S. Ritchey, dated October 7, 2010 (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed October 12, 2010). |
| 10.9*                  | Employment Arrangement between Pro-Dex, Inc. and Harold A. Hurwitz (incorporated herein by reference to Exhibit 10.2 to the Company's Form 8-K filed October 12, 2010).                       |
| 10.10*                 | Long-Term Incentive Plan as amended on October 7, 2010 (incorporated herein by reference to Exhibit 10.3 to the Company's Form 8-K filed October 12, 2010).                                   |

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- 10.11 Business Loan Agreement, dated as of February 4, 2011, between Pro-Dex, Inc. and Union Bank, National Association (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed February 10, 2011).
- 10.12 Revolving Credit Line Note, dated as of February 4, 2011, by Pro-Dex, Inc. in favor of Union Bank, National Association (incorporated herein by reference to Exhibit 10.2 to the Company's Form 8-K filed February 10, 2011).
- 10.13 Non-Revolving Credit Line Note, dated as of February 4, 2011, by Pro-Dex, Inc. in favor of Union Bank, National Association (incorporated herein by reference to Exhibit 10.3 to the Company's Form 8-K filed February 10, 2011).

Table of Contents

- 10.14 Term Loan Note, dated as of February 4, 2011, by Pro-Dex, Inc. in favor of Union Bank, National Association (incorporated herein by reference to Exhibit 10.4 to the Company's Form 8-K filed February 10, 2011).
- 10.15 Security Agreement, dated as of February 4, 2011, by Pro-Dex, Inc. in favor of Union Bank, National Association (incorporated herein by reference to Exhibit 10.5 to the Company's Form 8-K filed February 10, 2011).
- 10.16 Security Agreement, dated as of February 4, 2011, by Pro-Dex Astromec, Inc. in favor of Union Bank, National Association (incorporated herein by reference to Exhibit 10.6 to the Company's Form 8-K filed February 10, 2011.)
- 10.17\* Employee Severance Policy, adopted July 1, 2011 (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed July 7, 2011).
- 10.18\* Change of Control Agreement entered into between Pro-Dex, Inc. and Harold A. Hurwitz, dated July 19, 2011 (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed July 22, 2011).
- 10.19 Asset Purchase Agreement entered into by and among Pro-Dex, Inc., Pro-Dex Astromec, Inc., SL Montevideo Technology, Inc. and SL Industries, Inc., dated February 27, 2012 (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed March 1, 2012).
- 10.20\* Separation Agreement entered into between Pro-Dex, Inc. and Mark P. Murphy, dated April 19, 2012 (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed April 20, 2012).
- 10.21\* Employment Arrangement entered into between Pro-Dex, Inc. and Michael J. Berthelot, dated April 20, 2012 (incorporated herein by reference to Exhibit 10.3 to the Company's Form 8-K filed April 20, 2012).
- 10.22\* Change of Control Agreement entered into between Pro-Dex, Inc. and Michael J. Berthelot, dated April 20, 2012 (incorporated herein by reference to Exhibit 10.4 to the Company's Form 8-K filed April 20, 2012).
- 10.23 First Amendment to the Business Loan Agreement dated February 4, 2011 between Pro-Dex, Inc. and Union Bank, N.A., dated May 31, 2012 (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed June 5, 2012).
- 10.24 Letter from Union Bank, N.A. to Pro-Dex, Inc. dated September 4, 2012 (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed September 4, 2012).
- 10.25 Waiver of Director Compensation of Nick Swenson, dated February 4, 2013 (incorporated herein by reference to Exhibit 10.1 to the Company's Form 10-Q filed February 13, 2013).
- 10.26 Waiver of Director Compensation of Ray Cabillot, dated February 4, 2013 (incorporated herein by reference to Exhibit 10.2 to the Company's Form 10-Q filed February 13, 2013).

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- 10.27 Waiver of Director Compensation of William Farrell, dated February 4, 2013 (incorporated herein by reference to Exhibit 10.3 to the Company's Form 10-Q filed February 13, 2013).
- 10.28\* Separation Agreement and General Release of All Claims entered into between Pro-Dex, Inc. and Michael J. Berthelot, dated February 25, 2013 (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed February 25, 2013).
- 10.29\* Employment Arrangement entered into between Pro-Dex, Inc. and Harold A. Hurwitz, dated February 19, 2013 (incorporated herein by reference to Exhibit 10.2 to the Company's Form 8-K filed February 25, 2013).

Table of Contents

|        |  |
|--------|--|
| 10.30* | Employment Arrangement entered into between Pro-Dex, Inc. and Richard L. Van Kirk, dated April 23, 2013 (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed April 24, 2013).   |
| 10.31* | Employment Arrangement entered into between Pro-Dex, Inc. and Richard L. Van Kirk, dated January 6, 2006 (incorporated herein by reference to Exhibit 10.2 to the Company's Form 8-K filed April 24, 2013).  |
| 10.32* | Change of Control Agreement entered into between Pro-Dex, Inc. and Richard L. Van Kirk dated July 19, 2011 (incorporated herein by reference to Exhibit 10.3 to the Company's Form 8-K filed April 24, 2013).  |
| 10.33  | Purchase Agreement, dated April 22, 2013, by and between Pro-Dex, Inc. and Aesthetic and Reconstructive Technologies, Inc. (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed April 26, 2013).  |
| 10.34  | Letter from William L. Healey to Mr. Nick Swenson dated June 7, 2013 (incorporated herein by reference to Exhibit 99.1 to the Company's Form 8-K filed June 12, 2013).   |
| 10.35  | First Amendment To Lease – July 2013 by and between Irvine Business Properties and Pro-Dex, Inc., dated effective July 1, 2013 (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed July 17, 2013).   |
| 10.36  | Standby Purchase Agreement dated December 17, 2013, between the Registrant and AO Partners, LLC and Farnam Street Capital Inc (incorporated herein by reference to Exhibit 10.1 to the Registration Statement on Form S-3 filed by the Registrant on December 17, 2013)                            |
| 10.37  | Amendment No. 1 to Standby Purchase Agreement, dated March 3, 2014, between the Registrant and AO Partners, LLC and Farnam Street Capital Inc (incorporated herein by reference to Exhibit 10.2 to Amendment No. 1 to Registration Statement on Form S-3 filed by the Registrant on March 5, 2014) |
| 10.38  | Asset Purchase Agreement dated June 20, 2014 by and between Pro-Dex, Inc. and Hans Huber, sole proprietor of Huber Precision filed herewith.   |
| 10.39  | Amendment #1 to Asset Purchase Agreement dated August 4, 2014 by and between Pro-Dex, Inc. and Hans Huber, sole proprietor of Huber Precision filed herewith.  |
| 10.40  | Amendment #2 to Asset Purchase Agreement dated September 6, 2014 by and between Pro-Dex, Inc. and Hans Huber, sole proprietor of Huber Precision filed herewith.   |
| 21.1   | List of Subsidiaries (incorporated herein by reference to Exhibit 21.1 to the Company's Form 10-KSB filed September 28, 2007).   |
| 23     | Consent of Independent Registered Public Accounting Firm.  |
| 31     | Certification of the Chief Executive Officer and 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 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.

101.INS\*\* XBRL Instance Document

101.SCH\*\* XBRL Taxonomy Extension Schema Document

101.CAL\*\* XBRL Taxonomy Extension Calculation Linkbase Document

101.LAB\*\* XBRL Taxonomy Extension Label Linkbase Document

101.PRE\*\* XBRL Taxonomy Extension Presentation Linkbase Document

50

Table of Contents

101.DEF\*\* XBRL Extension Definition Linkbase Document

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

\*\* Pursuant to applicable securities laws and regulations, the Company is deemed to have complied with the reporting obligation relating to the submission of interactive data files in such exhibits and are not subject to liability under any anti-fraud provisions of the federal securities laws as long as the Company has made a good faith attempt to comply with the submission requirements and promptly amend the interactive data files after becoming aware that the interactive data files fail to comply with the submission requirements. Users of this data are advised that, pursuant to Rule 406T, these interactive data files are deemed not filed and otherwise are not subject to liability.