PRO DEX INC
Form 10KSB
September 28, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-KSB

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended June 30, 2005

OR

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

Commission File Number 0-14942

PRO-DEX, INC.

(Name of small business issuer in its charter)

Colorado	**84-1261240**
(State or Other Jurisdiction of Incorporation or Organization)	**(IRS Employer Identification No.)**

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

Issuer's telephone number: (714) 241-4411

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

Title of each class	**Name of each exchange on which registered**
None	**None**

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

Common stock, no par value
(Title of class)

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

Yes [X] No [ ]

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. [X]

Issuer's revenues for its most recent fiscal year were $13,834,000.

The aggregate market value of the voting stock held by non-affiliates computed by reference to the closing price as of September 19, 2005 was $27,648,000. For the purpose of this calculation, shares owned by officers, directors and 10% stockholders known to the registrant have been deemed to be owned by affiliates. This determination of affiliate status is not a determination for other purposes.

Indicate the number of shares outstanding of each of the issuer's classes of Common Stock outstanding as of the latest practicable date: 9,544,912 shares of Common Stock, no par value, as of September 19, 2005.

DOCUMENTS INCORPORATED BY REFERENCE: Part III incorporates by reference certain information from the registrant's definitive proxy statement (the "Proxy Statement") for the 2005 Annual Meeting of Shareholders. Certain exhibits are set forth in the Exhibit Index. The Exhibit Index begins on sequentially numbered page 37.

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

PART I

Cautionary statement pursuant to safe harbor provisions of the Private Securities Litigation reform act of 1995.

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

Item 1. Description of Business

Company Overview

Pro-Dex, Inc. ("Company," "Pro-Dex", "we," "our,", "us") is a Colorado corporation that was chartered in 1978, and specializes in bringing speed to market in the development and manufacture of technology-based solutions that incorporate embedded motion control and miniature rotary drive systems. We design and manufacture products serving the medical, dental, factory automation and scientific research markets. Our strategic value proposition is to get customers to market faster, at a lower total cost and with a higher quality product. Products that we have developed and manufactured are used in hospitals, dental offices, medical engineering labs, scientific research facilities and high tech manufacturing operations around the world. Until June 30, 2004, Pro-Dex had a "holding company" legal structure that had become increasingly cumbersome for the efficient operation of the Company. In the fiscal year ended June 30, 2004, we eliminated the Company's holding company structure and terminated the separate legal status of our then operating subsidiaries, Micro Motors, Inc. ("Micro Motors") headquartered in Santa Ana, California and Oregon Micro Systems, Inc. ("OMS") headquartered in Beaverton, Oregon, through the merger of each such subsidiary into the Company. As a result, we no longer operate as a holding company but as one integrated business operating in two locations providing a broad range of systems solutions to our customers. The company names of Micro Motors and Oregon Micro Systems will continue to be used for marketing purposes as brand names.

Pro-Dex's principal headquarters are located at 151 E. Columbine Avenue, Santa Ana, California 92707 and our phone number is 714-241-4411. Our Internet address is www.pro-dex.com. Our annual reports on Form 10-KSB, quarterly reports on Form 10-QSB, current reports on Form 8-K, amendments to those reports and other Securities and Exchange Commission ("SEC") filings, are available free of charge through our website as soon as reasonably practicable after such reports are electronically filed with, or furnished to, the SEC. In addition, our Code of Ethics and other corporate governance documents may be found on our website at the Internet address set forth above. Our filings with the SEC may also be read and copied at the SEC's Public Reference Room at 450 Fifth Street, N.W., Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC at www.sec.gov.

Description of Business

The majority of our revenue is derived from designing, developing and manufacturing electric, air, and battery powered rotary drive systems for the medical device and dental industries, and motion control software and hardware for industrial and scientific applications. We also distribute our own line of pneumatic and electric dental hand pieces sold under the Micro Motors name utilizing a network of independent sales representatives across North America. A large part of our recent revenue growth has been driven by developing and selling numerous private label rotary drive systems for use in dental, cranial, spinal, arthroscopic and orthopedic surgery. Other revenue sources include designing and manufacturing miniature pneumatic motors and motion control systems for industrial applications in the automotive, aerospace, apparel and entertainment industries.

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

Company-funded research and development supports the development of generic rotary drive and motion control platforms. We then seek customer-funded projects to customize these platforms to specific customer requirements. Company-funded research and development projects are generally expected to convert to customer-funded projects within six to eighteen months. Company funded project costs are expensed as incurred. In the year ended June 30, 2005, $1,740,000 was expensed; a decrease of $50,000 from the $1,790,000 expensed in the year ended June 30, 2004.

For customer-funded development projects, costs are capitalized and recognized as a cost of sales when specific deliverables within the development contracts are produced, matching the costs to the revenue. In the year ended June 30, 2005, $144,000 was recognized as cost of sales, compared to $221,000 recognized as cost of sales in the year ended June 30, 2004. In the three months ended June 30, 2005, $13,000 was recognized as cost of sales, compared to $20,000 recognized as cost of sales in the three months ended June 30, 2004, reflecting the completion of new product launches this quarter.

Customer-funded research and development provided $566,000 in revenue for the year ended June 30, 2005, and $426,000 in revenue in the year ended June 30, 2004. Customer-funded research and development provided $29,000 in revenue in the three months ended June 30, 2005, and $127,000 in revenue in the three months ended June 30, 2004. The results of customer-funded development work are intended to provide long-term exclusive manufacturing agreements and provide the customer with the retention of the intellectual property developed. The identity of the customer is generally protected by a non-disclosure agreement.

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

% of Total Sales	FY 2005	FY 2004	FY 2003	FY 2002
Dental	24%	32%	43%	54%
Medical	42%	41%	28%	17%
Industrial	26%	18%	19%	19%
Government research and other	8%	9%	10%	10%

Medical product sales represent the manufacture of products which utilize proprietary designs developed by the Company under exclusive design and supply agreements. Our dental products are sold to original equipment manufacturers and dental product distributors. An independent dealer network was engaged in 2003 to market our own branded line of dental products in a more effective manner. We also design and manufacture embedded multi-axis motion controllers used to regulate the motion of servo and stepper motors, predominantly for the factory automation and medical analysis equipment industries. The controllers support the platforms for PCI, VME, ISA, and cPCI busses as well as stand-alone requirements. In addition, we make and sell pneumatic motors for industrial applications that are marketed directly to end-users and through industrial supply distributors. The increase in the percentage of sales of medical products and the decrease in the percentage of sales of dental product sales is a direct result of the shift in the focus of our research and development efforts away from dental products and toward our capabilities in the medical product market.

Of Pro-Dex sales in 2005, over 15% were shipments of products developed in the last 12 months and 24% were shipments of products developed in the last 24 months. Of Pro-Dex sales in 2004, over 16% were shipments of products developed in the previous 12 months and 31% were shipments of products developed in the previous 24 months.

In 2005, the top 20 customers accounted for 69% of our sales, compared to 72% in 2004. In 2005, our three largest customers accounted for 31% of such sales with one customer accounting for over 17% of sales. This compares to 2004 when our three largest customers accounted for 32% of our sales with the largest customer accounting for 17%. No other customer accounted for over 10% of sales in either year. Our larger customers include Smith and Nephew, Medtronics, Sullivan Schein, Karl Storz, Walter Lorenz, Applied Materials and Pemstar. In some cases, disclosure of other larger customer names is prohibited by confidentiality agreements with such entities. Our medical and industrial customers are typically larger companies, while our dental products customers are typically smaller companies. We have no plans to discontinue the sales relationships with our existing significant customers, and have no knowledge that these significant customers have any plans to discontinue their relationships with us, although the relationships may change over time.

All of the raw materials used to manufacture of our products are purchased from various suppliers and are available from several sources. Precipart Corporation, Insight Electronics, LLC and Avenet Electronics Marketing are some examples of our key suppliers. We consider our relationships with our suppliers and manufacturers to be good. We do not intend to terminate any such relationship at this time, nor does management have knowledge that any supplier or manufacturer intends to terminate its relationship with Pro-Dex. Pro-Dex has no exclusive arrangements with any of its suppliers or manufacturers.

Our commitment to quality manufacturing is demonstrated by our three independently verified certifications for maintaining quality processes and products. We hold the following certifications: ISO 9001:2000, ISO 13485 revised 1998, and Medical Device Directive 93\42\EEC Annex II company.

At the present time, we are generally able to fill orders within sixty (60) days. At June 30, 2005, we had a backlog, including orders for delivery beyond 60 days, of $7.9 million compared with a backlog of $5.1 million at June 30, 2004. We expect to ship most of our backlog in 2006 and the remainder in 2007. The increased backlog is due to the receipt of several high-value, long-term purchase orders in the last fiscal year from new and existing customers. We do not typically experience seasonal fluctuations in our new order bookings, but may experience variability in our new order bookings due to the timing of major new product launches. Similarly, we do not typically experience seasonal fluctuations in our shipments and revenues.

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

The Pro-Dex corporate structure has continued to evolve since the divestiture of the Company's Biotrol and Challenge subsidiaries in June of 2001 through the recent elimination of the holding company structure and consolidation of the remaining operating subsidiaries in June of 2004. Coincident with the dental consumable subsidiary sale in 2001, our executive operations in Colorado were consolidated into the facilities in Santa Ana, California. This and other efforts to streamline our structure and reduce corporate overhead saved approximately $980,000 in 2003 as compared to 2002, primarily in reduced lease costs, eliminated management salary costs and reduced consulting fees. We saved an additional $133,000 in 2004 as compared to 2003 and an additional $148,000 in 2005 as compared to 2004, insurance, legal, and consulting costs were reduced further.

Competition

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

than we do.

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

Research and Development

We conduct company-wide and project specific research and development programs. These product development programs are important to both maintain and improve our market position. The net amounts spent on research and development activities in 2005 and 2004 were approximately $1.74 million and $1.79 million, respectively. Our research and development effort involves the design and manufacture of products that perform specific applications for our customers. We continue to target our research and development expenses toward three goals:

1. expanding our customer base in the medical device industry

2. general technical advances, and

3. enhancements of current product lines.

We continue to gain a greater commitment level from our customers to share research and development costs by billing them for non-recurring engineering expenses. The fees received for non-recurring engineering expenses do not, however, represent a significant portion of our revenue.

Employees

At June 30, 2005, we had 87 full-time employees compared to 82 full-time and 1 part-time employees at June 30, 2004. As of June 30, 2005, there were 74 persons employed at the Santa Ana location and 13 persons employed at the Beaverton location compared to 68 persons employed at the Santa Ana location and 15 persons employed at the Beaverton location at June 30, 2004. We have increased the use of temporary labor from temporary staffing agencies as a response to our accelerating sales rate during the fourth quarter and employed 15 agency temps at June 30, 2005, which is an increase from 2 at June 30, 2004.

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

Government Regulations

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

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

and processes fully comply with applicable laws and regulations, we are unable to predict the outcome of any such investigation or review, pending its completion.

Management believes that our business in the assembly and distribution of multi-axis motion control circuit boards, including the processes and materials, is conducted in a manner consistent with Environmental Protection Agency ("EPA") regulations governing disposition of industrial waste materials. While our management is confident that our products and processes fully comply with applicable laws and regulations, we are unable to predict the outcome of any investigation or review which may in the future be undertaken with respect to our products or processes.

Management believes that we follow good manufacturing practices for all of our products at each of its locations.

Patents, Trademarks, and Licensing Agreements

We hold patents relating to multi-axis motion controllers and our miniature rotary drive products. Our patents have varying expiration dates. The expiration of the patents is not expected to cause any change in the Company's revenue generating operations.

We conducted a limited review of the patents acquired in connection with the 1995 OMS and Micro Motors acquisitions and believe that the use of such patents is neither infringed upon by any third party, nor infringes on any prior art of any third party. We are unable to assess the validity, scope, or defensibility of our patents, and any challenge to or claim of infringement relating to our patents could materially and adversely affect our business and results of operations, although management believes it is more likely than not for a claim to not have a material and adverse effect on our revenue generating operations.

We have certain trademarks relating to our miniature pneumatic motor products, including Dynatorq™, Dynasurg™, PDL™, and Micro Handpiece™. We have filed for federal trademark protection for OMS-EZ™ and Canaligator™.

We have not entered into any licensing or franchising agreements for revenue generating purposes.

RISK FACTORS

Competition

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

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

Fluctuation in Quarterly Operating Results

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

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

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

Dependence on Principal Products and New Product Development

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

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

Technological Change

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

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

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

Litigation

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

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

Proprietary Technology

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

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

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

Ability to Manage Growth

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

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

Dependence Upon Key Personnel

Our future performance also depends in significant part upon the continued service of our key technical and senior management personnel, many of who have been with the Company for a significant period of time. We purchased a one-year term key man life insurance policy for the president in December 2004, but do not maintain key man life insurance on any other of our employees. Because we have a relatively small number of employees when compared to

other leading companies in the same industry, our dependence on maintaining our relationship with key employees is particularly significant. We are also dependent on our ability to attract and retain high quality personnel, particularly in the areas of product development, operations management and finance.

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

Product Liability

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

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

Accounting Matters

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

Internal Controls

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

Stock Option Expense

Stock options have from time to time been an important component of the compensation packages for many of our directors and employees. We currently do not deduct the expense of director or employee stock option grants from our income. As issued on December 16, 2004, FAS 123 (r) requires companies to change their accounting policies to record the value of stock options vested as an expense and a charge against earnings. We are a small business issuer and thus the rule would require that we comply at the beginning of the first fiscal year after December 15, 2005, so reports issued for dates after July 1, 2006 will reflect the change and our reported earnings will be adversely affected.

Item 2. Description of Property

Our executive offices and Santa Ana manufacturing facility are located at 151 East Columbine Avenue, Santa Ana, California 92707. We lease the 18,000 square foot facility from an unrelated third party at a base monthly lease rate of $14,000 through July 2006. The building is a two-story stand-alone building of concrete tilt-up construction, approximately 30 years old and in good condition.

Our Beaverton office and manufacturing facility is located at 1800 N.W. 169th Place, Building C100, Beaverton, Oregon 97006. The Company leases the 11,000 square foot facility from an unrelated third party, at a base monthly lease rate of $9,600 through October 2007. The building is a one-story suite in a 15-year-old industrial office complex and in good condition.

Our management believes that the monthly rental rates are comparable to rents charged for comparable properties in the market area. We believe that the current facilities are adequate for our expected needs. We believe there is full compliance with applicable state and EPA environmental standards at each facility.

Item 3. Legal Proceedings

The manufacture and distribution of certain products by us involves a risk of legal action, and, from time to time, our being named as a defendant in lawsuits. While our management believes that these matters will not have a material adverse impact on the financial condition of the Company, there can be no certainty that we may not ultimately incur liability or that such liability will not be material and adverse.

We are a party to various legal proceedings incidental to our business, none of which we consider to be material at this time.

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

No matter was submitted to a vote of our shareholders during the fourth quarter ended June 30, 2005.

PART II

Item 5. Market for Common Equity, Related Stockholder Matters and Small Business Issuer Purchases of Equity Securities

Our no par value common stock is quoted under the symbol "PDEX" on the automated quotation system of the National Association of Securities Dealers SmallCap Market ("NASDAQ"). The following table sets forth for the quarters indicated the high and low sales prices as reported by NASDAQ. The quotations reflect inter-dealer prices, without retail markup, markdown, or commissions, and may not necessarily represent actual transactions.

Quarter Ended	High	Low
September 30, 2003	2.00	1.35
December 31, 2003	3.20	1.40
March 31, 2004	3.19	2.30
June 30, 2004	2.75	1.80
September 30, 2004	3.18	1.86
December 31, 2004	2.92	2.50
March 31, 2005	3.30	2.67
June 30, 2005	3.56	2.50

On September 19, 2005, the last sale price of our common stock as reported by NASDAQ was $3.49 per share.

At June 30, 2005, there were approximately 295 holders of record of our common stock. This number does not include beneficial owners including holders whose shares are held in nominee or "street" name.

We have not paid a cash dividend with respect to our common stock, and have no present intention to pay cash dividends in the foreseeable future. The current policy of our Board of Directors is to retain earnings to provide funds for the operation and expansion of the business. The Board of Directors, in light of the circumstances then existing, including our earnings and financial requirements and general business conditions, will determine future dividends. There are no restrictions associated with our credit line on the Company in issuing dividends.

Equity Compensation Plan Information

As of June 30, 2005 Plan Category	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights	Weighted Average Exercise Price of Outstanding Options, Warrants and Rights	Number of Securities Available for Issuance Under Equity Compensation Plans (excluding services reflected in column (a))
	(a)	(b)	(c)
Plans Approved by Stockholders	1,046,816	$1.40	535,545
Plans Not Approved by Stockholders	163,000	1.62	---
Total	1,209,816	$1.43	535,545

The Company made no repurchases of its securities during the fourth quarter ended June 30, 2005.

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

The following discussion and analysis provides information that our management believes is relevant to an assessment and understanding of the Company's results of operations and financial condition for each of the two years ended June 30, 2004 and 2005, respectively. This discussion should be read in conjunction with the Consolidated Financial Statements and the Notes thereto included elsewhere in this Report. This Report contains certain forward-looking statements and information. The cautionary statements included herein should be read as being applicable to all related forward-looking statements wherever they may appear. Our actual future results could differ materially from those discussed herein.

Critical Accounting Estimates and Judgments

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States. The preparation of our financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosures. We base our estimates on historical experience and various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates. The significant accounting policies that are believed to be the most critical to fully understanding and evaluating the reported financial results include inventory valuations for slow moving items, establishing reserves for valuation of accounts receivable, impairment of goodwill, and the recovery of deferred income tax assets.

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

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

On July 1, 2002 we adopted SFAS No. 142 "Goodwill and Other Intangible Assets." SFAS No. 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead tested for impairment at least annually in accordance with the provisions of SFAS No. 142.An impairment test was completed in accordance with the requirements of SFAS No. 142, and no impairment charge in 2005 or 2004 was recorded. We prepare our annual impairment testing on April 1 of each year.

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

in the statement of operations.

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

RESULTS OF OPERATIONS

Results of Operations for Fiscal Year Ended June 30, 2005, Compared to Fiscal Year Ended June 30, 2004

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

(In Thousands)	Fiscal Year Ended June 30,			
	2005		2004	
Net sales:	$ 13,834	100.0%	$ 14,200	100.0%
Cost of sales	6,754	48.8%	7,395	52.1%
Gross Profit	7,080	51.2%	6,805	47.9%
Selling, general and administrative expenses	3,048	22.0%	3,182	22.4%
Research and development costs	1,740	12.6%	1,790	12.6%
Income from Operations	2,292	16.6%	1,833	12.9%
Net interest and other (income)	(138)	(1.0%)	(69)	(0.5%)
Provision for Income Taxes	581	4.2%	782	5.5%
Net Income	$ 1,849	13.4%	$ 1,120	7.9%

Net Sales. Consolidated sales decreased 2.5% for the year ended June 30, 2005, compared to the year ended June 30, 2004, due to decreased dental product sales as approximately $675,000 of Healozone product sales made in the first half of 2004 were replaced by a royalty agreement from which income is reported as below the operating profit line as royalty income. Two other products were transitioning to next generation designs, so their sales were reduced by over $400,000 compared to the prior year. Medical sales continued to represent a majority of the revenue as they comprised 42% of total sales, slightly higher than the 41% of total sales in 2004. Industrial sales increased significantly as the semiconductor industry rebounded from its cyclical downturn and we were able to capitalize on sales outside the semiconductor area. Although selective price increases and decreases were implemented in response to market conditions, the majority of the sales growth and declines for each product line is due to increased or decreased sales volume, not the effect of these price changes. Our revenue is derived from four main customer types. The amount of Pro-Dex total sales to each customer type is noted in the table below:

	Fiscal Year ended June 30, 2005	2004	Increase/ (Decrease)
Dental	$ 3,368,000	$ 4,578,000	(26%)
Medical	5,849,000	5,864,000	(0%)
Industrial	3,570,000	2,533,000	41%
Government research and other	1,047,000	1,225,000	(15%)
Total	$ 13,834,000	$ 14,200,000	(3%)

Gross Profit The Company's consolidated gross profit for 2005 increased $275,000 or 4% over the gross profit in the previous year despite a decline in sales as lower margin dental sales were replaced by higher margin industrial sales. Gross profit as a percentage of sales increased to 51% for the year ended June 30, 2005 compared to 48% for the year ended June 30, 2004 for the same reasons as noted above and the realization of continued gains from manufacturing cost improvements. Gross profit and gross profit percentage were as follows:

	Fiscal Year ended June 30, 2005	2004	Increase
Gross Profit	$7,080,000	$6,805,000	4.0%
Gross Profit Percentage	51.2%	47.9%	6.8%

Selling, general and administrative costs (S, G&A). S, G & A expenses decreased 4.2% to $3,048,000 for the year ended June 30, 2005 from $3,182,000 for year ended June 30, 2004. The decrease is mainly due to a reduction in legal, insurance and other administrative costs of $234,000 offset by a $60,000 increase in bad debt allowance and $40,000 in sales and marketing expenses. S, G & A costs were as follows:

	Fiscal Year ended June 30, 2005	2004	Increase (Decrease)
Selling	$ 957,000	$ 857,000	11.7%
General and administrative	$ 2,091,000	$ 2,325,000	(10.1%)
Total S, G&A			