

PRO DEX INC  
Form 10-Q  
February 13, 2013  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended December 31, 2012

OR

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

FOR THE TRANSITION PERIOD FROM            TO            .

Commission File Number 0-14942

**PRO-DEX, INC.**

(Exact name of registrant as specified in its charter)

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**Colorado**  
(State or Other Jurisdiction of

**84-1261240**  
(IRS Employer

Incorporation or Organization)

Identification No.)

**2361 McGaw Avenue, Irvine, California 92614**

(Address of Principal Executive Offices)

**Registrant's telephone number: 949-769-3200**

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 twelve months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past ninety days. Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

Indicate the number of shares outstanding of each of the Registrant's classes of Common Stock outstanding as of the latest practicable date:  
3,340,684 shares of Common Stock, no par value, as of February 1, 2013.

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**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements****PRO-DEX, INC. and SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS****(unaudited)**

	December 31, 2012	June 30, 2012
<b>ASSETS</b>		
Current assets:		
Cash	\$ 2,549,000	\$ 4,112,000
Accounts receivable, net of allowance for doubtful accounts of \$13,000 at December 31, 2012 and \$16,000 at June 30, 2012	1,175,000	1,581,000
Other current receivables	90,000	123,000
Inventories	3,515,000	2,791,000
Prepaid expenses	237,000	172,000
Income taxes receivable	570,000	609,000
Deferred income taxes	109,000	109,000
Total current assets	8,245,000	9,497,000
Property, plant, equipment and leasehold improvements, net	2,290,000	2,539,000
Real estate held for sale	733,000	733,000
Other assets	53,000	53,000
Total assets	\$ 11,321,000	\$ 12,822,000
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 576,000	\$ 633,000
Accrued expenses	1,008,000	1,425,000
Income taxes payable	47,000	47,000
Bank term loan		774,000
Total current liabilities	1,631,000	2,879,000
Non-current liabilities:		
Deferred income taxes	109,000	109,000
Deferred rent	280,000	284,000
Total non-current liabilities	389,000	393,000
Total liabilities	2,020,000	3,272,000
Commitments and contingencies		
Shareholders' equity:		
Common shares; no par value; 50,000,000 shares authorized; 3,340,684 and 3,272,350 shares issued and outstanding at December 31, 2012 and June 30, 2012, respectively	16,962,000	16,846,000
Accumulated deficit	(7,661,000)	(7,296,000)
Total shareholders' equity	9,301,000	9,550,000

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Total liabilities and shareholders' equity	\$	11,321,000	\$	12,822,000
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*See notes to condensed consolidated financial statements.*

**Table of Contents****PRO-DEX, INC. and SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(unaudited)**

	For The Three Months Ended December 31,	
	2012	2011
Net sales	\$ 3,007,000	\$ 4,017,000
Cost of sales	1,974,000	2,770,000
Gross profit	1,033,000	1,247,000
Operating expenses:		
Selling expenses	322,000	369,000
General and administrative expenses	627,000	688,000
Research and development costs	464,000	508,000
Total operating expenses	1,413,000	1,565,000
Loss from continuing operations before items below	(380,000)	(318,000)
Other expense:		
Interest expense		(10,000)
Total other expense		(10,000)
Loss from continuing operations before provision for (benefit from) income taxes	(380,000)	(328,000)
Provision for (benefit from) income taxes	(16,000)	1,000
Loss from continuing operations	(364,000)	(329,000)
Income from discontinued operations, net of provision for income taxes of \$21,000 in 2012 and \$0 in 2011	16,000	37,000
Net loss	\$ (348,000)	\$ (292,000)
Per share data:		
Loss from continuing operations		
Basic	\$ (0.11)	\$ (0.10)
Diluted	\$ (0.11)	\$ (0.10)
Income from discontinued operations		
Basic	\$	\$ 0.01
Diluted	\$	\$ 0.01
Net loss		
Basic	\$ (0.11)	\$ (0.09)
Diluted	\$ (0.11)	\$ (0.09)
Weighted average shares outstanding basic	3,319,180	3,272,350
Weighted average shares outstanding diluted	3,319,180	3,272,350

*See notes to condensed consolidated financial statements.*

**Table of Contents****PRO-DEX, INC. and SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(unaudited)**

	For The Six Months Ended December 31,	
	2012	2011
Net sales	\$ 6,468,000	\$ 9,062,000
Cost of sales	4,199,000	5,707,000
Gross profit	2,269,000	3,355,000
Operating expenses:		
Selling expenses	596,000	743,000
General and administrative expenses	1,234,000	1,504,000
Research and development costs	870,000	1,069,000
Total operating expenses	2,700,000	3,316,000
Income (loss) from continuing operations before items below	(431,000)	39,000
Other expense:		
Interest expense	(6,000)	(20,000)
Total other expense	(6,000)	(20,000)
Income (loss) from continuing operations before provision for (benefit from) income taxes	(437,000)	19,000
Provision for (benefit from) income taxes	(19,000)	2,000
Income (loss) from continuing operations	(418,000)	17,000
Income from discontinued operations, net of provision for income taxes of \$25,000 in 2012 and \$0 in 2011	53,000	137,000
Net income (loss)	\$ (365,000)	\$ 154,000
Per share data:		
Income (loss) from continuing operations		
Basic	\$ (0.13)	\$ 0.01
Diluted	\$ (0.13)	\$ 0.01
Income from discontinued operations		
Basic	\$ 0.02	\$ 0.04
Diluted	\$ 0.02	\$ 0.04
Net income (loss)		
Basic	\$ (0.11)	\$ 0.05
Diluted	\$ (0.11)	\$ 0.05
Weighted average shares outstanding basic	3,299,379	3,272,350
Weighted average shares outstanding diluted	3,299,379	3,292,508

**Table of Contents****PRO-DEX, INC. and SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(unaudited)**

	For The Six Months Ended December 31,	
	2012	2011
<b>Cash flows from operating activities:</b>		
Net income (loss)	\$ (365,000)	\$ 154,000
<b>Adjustments to reconcile net income (loss) to net cash used in operating activities:</b>		
Depreciation and amortization	298,000	339,000
Allowance for doubtful accounts	(3,000)	6,000
Share-based compensation	65,000	33,000
<b>Changes in:</b>		
Accounts receivable and other current receivables	440,000	834,000
Inventories	(724,000)	(1,030,000)
Prepaid expenses	(65,000)	(88,000)
Other assets		8,000
Accounts payable and accrued expenses	(476,000)	(213,000)
Income taxes receivable and payable	39,000	(49,000)
<b>Net cash used in operating activities</b>	<b>(791,000)</b>	<b>(6,000)</b>
<b>Cash flows from investing activities:</b>		
Purchases of equipment	(48,000)	(237,000)
<b>Net cash used in investing activities</b>	<b>(48,000)</b>	<b>(237,000)</b>
<b>Cash flows from financing activities:</b>		
Proceeds from exercise of stock options	50,000	
Principal payments on term loan	(774,000)	(179,000)
<b>Net cash used in financing activities</b>	<b>(724,000)</b>	<b>(179,000)</b>
<b>Net decrease in cash</b>	<b>(1,563,000)</b>	<b>(422,000)</b>
Cash, beginning of period	4,112,000	4,689,000
<b>Cash, end of period</b>	<b>\$ 2,549,000</b>	<b>\$ 4,267,000</b>
<i>Supplemental Information</i>		
Cash payments for interest	\$ 9,000	\$ 10,000
Cash payments for income taxes	\$ 5,000	\$ 53,000

*See notes to condensed consolidated financial statements.*



**Table of Contents****PRO-DEX, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(unaudited)****NOTE 1. BASIS OF PRESENTATION**

The accompanying unaudited condensed consolidated financial statements of Pro-Dex, Inc. ( we , us , our , Pro-Dex or the Company ) have been prepared in accordance with accounting principles generally accepted in the United States ( GAAP ) for interim financial information and with the instructions to Form 10-Q and Regulation S-K. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. These financial statements should be read in conjunction with the consolidated financial statements presented in our Annual Report on Form 10-K, as amended, for the fiscal year ended June 30, 2012. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. The results of operations for such interim periods are not necessarily indicative of the results that may be expected for the full year. For further information, refer to the consolidated financial statements and footnotes thereto included in our Annual Report on Form 10-K, as amended, for the year ended June 30, 2012.

**NOTE 2. INVENTORIES**

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

	December 31, 2012	June 30, 2012
Raw materials	\$ 1,501,000	\$ 1,087,000
Work in process	657,000	579,000
Finished goods	1,357,000	1,125,000
Total inventories	\$ 3,515,000	\$ 2,791,000

**NOTE 3. WARRANTY**

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. As of December 31, 2012 and June 30, 2012, the warranty reserve related to continuing operations amounted to \$361,000 and \$526,000, respectively. 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. Total warranty expense from continuing operations for the three months ended December 31, 2012 and 2011 was \$79,000 and \$271,000, respectively, and for the six months ended December 31, 2012 and 2011 was \$236,000 and \$499,000, respectively.

Information regarding the accrual for warranty costs relating to continuing operations for the three and six months ended December 31, 2012 and 2011 are as follows:

	Three months Ended December 31,	
	2012	2011
Balances, beginning of period	\$ 585,000	\$ 678,000
Accruals during the period	38,000	134,000
Changes in estimates of prior period accruals	41,000	137,000
Warranty expenditures	(303,000)	(254,000)
Balances, end of period	\$ 361,000	\$ 695,000

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	Six months Ended December 31,	
	2012	2011
Balances, beginning of period	\$ 526,000	\$ 688,000
Accruals during the period	186,000	271,000
Changes in estimates of prior period accruals	50,000	228,000
Warranty expenditures	(401,000)	(492,000)
Balances, end of period	\$ 361,000	\$ 695,000

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The changes in estimates recorded during the three and six months ended December 31, 2012 and 2011 were due primarily to fluctuations in per-unit warranty repair costs and return rates and the effects of those fluctuations on our estimates of future warranty repair costs.

**NOTE 4. NET INCOME (LOSS) PER SHARE**

The difference in the weighted average shares outstanding used in the calculation of basic and diluted net income (loss) per share for the three and six months ended December 31, 2012 and 2011 is as follows:

	Three Months Ended December 31,	
	2012	2011
<b>Numerators for basic and diluted per share data:</b>		
Loss from continuing operations	\$ (364,000)	\$ (329,000)
Income from discontinued operations	16,000	37,000
Net loss	\$ (348,000)	\$ (292,000)
<b>Denominators for basic and diluted per share data:</b>		
<b>Basic:</b>		
Weighted average common shares outstanding	3,319,180	3,272,350
Shares used in the computation of basic per share data	3,319,180	3,272,350
<b>Diluted:</b>		
Shares used in the computation of basic per share data	3,319,180	3,272,350
Net shares assumed issued using the treasury stock method for outstanding common stock options		
Shares used in the computation of diluted per share data	3,319,180	3,272,350
<b>Basic per share data:</b>		
Loss from continuing operations	\$ (0.11)	\$ (0.10)
Income from discontinued operations		0.01
Net loss	\$ (0.11)	\$ (0.09)
<b>Diluted per share data:</b>		
Loss from continuing operations	\$ (0.11)	\$ (0.10)
Income from discontinued operations		.01
Net loss	\$ (0.11)	\$ (0.09)

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	Six Months Ended December 31,	
	2012	2011
<b>Numerators for basic and diluted per share data:</b>		
Income (loss) from continuing operations	\$ (418,000)	\$ 17,000
Income from discontinued operations	53,000	137,000
Net income (loss)	\$ (365,000)	\$ 154,000
<b>Denominators for basic and diluted per share data:</b>		
<b>Basic:</b>		
Weighted average common shares outstanding	3,299,379	3,272,350
Shares used in the computation of basic per share data	3,299,379	3,272,350
<b>Diluted:</b>		
Shares used in the computation of basic per share data	3,299,379	3,272,350
Net shares assumed issued using the treasury stock method for outstanding common stock options		20,158
Shares used in the computation of diluted per share data	3,299,379	3,292,508
<b>Basic per share data:</b>		
Income (loss) from continuing operations	\$ (0.13)	\$ 0.01
Income from discontinued operations	0.02	0.04
Net income (loss)	\$ (0.11)	\$ 0.05
<b>Diluted per share data:</b>		
Income (loss) from continuing operations	\$ (0.13)	\$ 0.01
Income from discontinued operations	0.02	0.04
Net income (loss)	\$ (0.11)	\$ 0.05

Potentially dilutive securities, consisting of options to purchase shares of our common stock as described in Note 8, are not included in the calculation of diluted loss per share due to their anti-dilutive effect on the diluted loss per share calculations. Shares represented by such securities amount to 14,128 and 42,340 for the three months ended December 31, 2012 and 2011, respectively, and 8,511 for the six months ended December 31, 2012.

For the six months ended December 31, 2011, options having exercise prices that are greater than the average per share market price for our common stock, representing 243,340 shares, have been excluded from the diluted per share calculation due to their anti-dilutive effect.

**NOTE 5. BANK DEBT**

On February 4, 2011, we entered into a credit facility agreement with Union Bank, N.A. that provided for the following:

A revolving credit line of up to \$1.5 million in borrowing availability, under which no amounts were borrowed;

A non-revolving credit line of up to \$350,000 in borrowing availability for the purchase of equipment, which expired unused on February 4, 2012; and

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A term loan of \$1.25 million, the outstanding balance of which, amounting to \$685,000, was repaid in full on September 24, 2012, as discussed further below.

The maximum amount of borrowing under the revolving credit line was the lesser of:

- (a) \$1,500,000; or

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(b) the sum of 80% of eligible domestic accounts receivable, plus the lesser of:

(i) \$400,000; or

(ii) 15% of the eligible raw materials and finished goods inventories.

The revolving credit line's terms required monthly interest payments based on borrowed amounts at a floating interest rate, calculated as Union Bank's Reference Rate plus 0.5% (an aggregate interest rate of 3.75% during the term over which the line was in effect). The line's initial term was to expire on December 15, 2012.

The terms of the \$1.25 million term loan required monthly principal payments of \$29,762, plus interest over its 42-month term. The term loan bore interest at a floating rate, calculated as Union Bank's Reference Rate plus 0.5% (an aggregate interest rate of 3.75% during the term over which the loan was outstanding).

All personal property assets of the Company collateralized the outstanding borrowings under the Union Bank credit facility.

The credit facility agreements contained various covenants, including certain covenants measured annually based on fiscal year results, concerning our financial performance. At June 30, 2012, we were in violation of profitability-based covenants, for which the bank had the right to declare us in default of the bank credit facility agreements and the entire amount owing under the facility, consisting of the term loan, to become immediately due and payable.

On August 30, 2012, we notified the bank of our intent to terminate the credit facility agreements and repay the term loan in full, on or before September 30, 2012. By letter to us dated September 4, 2012, the bank waived, through October 1, 2012, the rights it otherwise would have had pursuant to the covenant violations described above. In conformity with the correspondence described in this paragraph, on September 24, 2012, we repaid the entire principal balance of the term loan, amounting to \$685,000, and the credit facility agreements were terminated.

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

**NOTE 6. DISCONTINUED OPERATIONS**

On February 27, 2012 (the Closing Date), we completed the sale of our fractional horsepower motor product line, operating under the name Pro-Dex Astromec (Astromec) and located in Carson City, Nevada, 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.

Upon closing of the sale and finalization of other items required by the APA, such as a physical inventory count, we recorded proceeds from the sale of \$756,000, equal to the net book value of the assets sold as of the Closing Date, summarized as follows:

Inventories	\$ 664,000
Equipment	82,000
Other	10,000
Total	\$ 756,000

Under the terms of the APA, we may 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, will be 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 will amount to 6%, 4% and 2% of the Earnout Sales Base in the first, second and third such years, respectively. The earnout payments

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will be recognized in the quarter in which we become entitled to receive them. For the three and six months ended December 31, 2012, we recognized income from earnout payments of \$45,000 and \$92,000, respectively, of which \$45,000 was included in other receivables in the accompanying December 31, 2012 consolidated balance sheet and was received in January 2013. An aggregate of \$157,000 in income from earnout payments has been recognized during the period from the Closing Date through December 31, 2012.

Also on the Closing Date, we entered into a Transition Production Agreement (the "TPA") with MTI, under which we provided MTI with manufacturing and certain administrative support services. MTI paid us for all our costs in providing the manufacturing services, and a fixed monthly amount for the administrative support services. In conformity with its terms, the TPA was terminated effective May 10, 2012.

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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:

	<b>Three Months Ended December 31,</b>	
	<b>2012</b>	<b>2011</b>
Revenues	\$ 45,000	\$ 890,000
Income before provision for income taxes	\$ 37,000	\$ 37,000
	<b>Six Months Ended December 31,</b>	
	<b>2012</b>	<b>2011</b>
Revenues	\$ 92,000	\$ 1,875,000
Income before provision for income taxes	\$ 78,000	\$ 137,000

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

	<b>December 31, 2012</b>	<b>June 30, 2012</b>
Other receivables	\$ 47,000	\$ 45,000
Other assets	\$ 17,000	\$
Accounts payable	\$ 4,000	\$ 3,000
Accrued expenses	\$ 8,000	\$ 25,000

Warranty reserves related to discontinued operations as of December 31, 2012 and June 30, 2012 amounted to \$5,000 and \$21,000, respectively. Warranty activities from discontinued operations for the three months ended December 31, 2012 and 2011 resulted in a credit of \$8,000 and expense of \$5,000, respectively, and for the six months ended December 31, 2012 and 2011 resulted in a credit of \$16,000 and expense of \$11,000, 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 we own in Carson City, Nevada, which are presented as assets held for sale in the accompanying December 31, 2012 and June 30, 2012 consolidated balance sheets with an aggregate carrying amount of \$733,000. We have evaluated the aggregate carrying amount of the land and building in relation to their aggregate estimated fair value less cost to sell, and have determined that an adjustment to such carrying amount was not required.

**NOTE 7. INCOME TAXES**

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

Significant management judgment is required in determining our provision for income taxes and the recoverability of our deferred tax assets. 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 during the past three years, we maintained a valuation allowance of \$2.7 million and \$2.6 million against our deferred tax assets as of December 31, 2012 and June 30, 2012, respectively. The change in valuation allowance is due primarily to the increase in deferred tax assets resulting from the pre-tax loss incurred for the six months ended December 31, 2012.



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As of December 31, 2012, we have accrued \$323,000 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. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

Balance at July 1, 2012	\$ 313,000
Additions based on tax positions related to the current year	10,000
Additions for tax positions of prior years	
Balance at December 31, 2012	\$ 323,000

Amounts accrued for unrecognized tax benefits are included as components of income taxes receivable or income taxes payable, as applicable, in the accompanying condensed consolidated balance sheets.

We recognize accrued interest and penalties related to unrecognized tax benefits in income tax expense when applicable. As of December 31, 2012 and June 30, 2012, 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.

Pro-Dex and its subsidiaries 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, 2009 and later. Our state income tax returns are open to audit under the statute of limitations for the years ended June 30, 2008 and later. We do not anticipate a significant change to the total amount of unrecognized tax benefits within the next 12 months.

**NOTE 8. SHARE-BASED COMPENSATION**

We have two equity compensation 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) (collectively, the Stock Option Plans), pursuant to which (i) options to purchase shares of common stock, or (ii) restricted shares of common stock, may 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 Stock Option Plans are 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 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 December 31, 2012, 219,966 and 81,667 shares under the Employees Stock Option Plan and the Directors Stock Option Plan, respectively, are available to grant in future years. Share-based compensation expense under the Stock Option Plans for the three months ended December 31, 2012 and 2011 were \$36,000 and \$21,000, respectively, and for the six months ended December 31, 2012 and 2011 was \$65,000 and \$33,000, respectively.

**Stock Options**

The following assumptions were used in the calculation of share-based compensation expense for options granted during the three months ended December 31, 2011 (no options were granted during the three months ended December 31, 2012), and the six months ended December 31, 2012 and 2011:

	<b>Three Months Ended December 31, 2011</b>
Dividend rate	None
Price volatility	88%
Risk-free interest rate	1.0%-1.2%
Expected life	5.5 years

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	Six Month Ended December 31,	
	2012	2011
Dividend rate	None	None
Price volatility	87%	62%
Risk-free interest rate	0.9%	1.0%-1.3%
Expected life	6.0 years	6.0 years

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As of December 31, 2012, there was an aggregate of \$259,000 of unrecognized compensation cost under the Stock Option Plans related to 329,000 non-vested outstanding stock options with a per share weighted average value of \$1.36. The unrecognized expense is anticipated to be recognized on a straight-line basis over a weighted average period of 2.2 years. Following is a summary of stock option activity for the six months ended December 31, 2012 and 2011:

	2012		2011	
	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price
Outstanding at beginning of period	591,672	\$ 2.48	320,842	\$ 2.71
Granted	35,000	1.73	205,000	2.04
Exercised	(33,334)	1.50		
Forfeited	(13,334)	7.74	(14,168)	2.43
Outstanding at end of period	580,004	\$ 2.37	511,674	\$ 2.65
Exercisable at end of period	250,976	\$ 2.96	244,591	\$ 3.32
Weighted-average fair value per option granted during the period		\$ 1.25		\$ 1.16

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Following is a summary of information regarding options outstanding and options exercisable at December 31, 2012:

Range of Exercise Price	Options Outstanding				Options Exercisable			
	Number Outstanding	Average Contractual Life	Average Exercise Price	Aggregate Intrinsic Value	Number Outstanding	Average Remaining Contractual Life	Average Exercise Price	Aggregate Intrinsic Value
\$1.35 to \$3.48	515,000	8.8 years	\$ 1.97	\$ 61,150	185,972	8.2 years	\$ 2.04	\$ 19,210
\$3.49 to \$5.62	50,003	3.2 years	4.81	\$ 0	50,003	3.2 years	4.81	\$ 0
\$5.63 to \$7.76	10,001	2.7 years	7.34	\$ 0	10,001	2.7 years	7.34	\$ 0
\$7.77 to \$9.90	5,000	2.5 years	9.90	\$ 0	5,000	2.5 years	9.90	\$ 0
<b>Total</b>	<b>580,004</b>	<b>8.2 years</b>	<b>\$ 2.37</b>	<b>\$ 61,150</b>	<b>250,976</b>	<b>6.9 years</b>	<b>\$ 2.96</b>	<b>\$ 19,210</b>

**Restricted Stock**

The following is a summary of restricted share activity for the six months ended December 31, 2012:

	Shares	Weighted-Average Grant Date Fair Value
Outstanding at beginning of year		
Granted	35,000	\$ 1.73
Vested		
Forfeited		
<b>Outstanding at end of period</b>	<b>35,000</b>	<b>\$ 1.73</b>

As of December 31, 2012, there was \$43,000 in unrecognized compensation cost related to non-vested outstanding restricted shares. The unrecognized expense is anticipated to be amortized over the next 2.7 fiscal years.

There was no restricted share activity during the six months ended December 31, 2011, nor were any restricted shares outstanding during the period.

**NOTE 9. MAJOR CUSTOMERS**

Information with respect to two customers who accounted for sales in excess of 10% of our total sales in any of the three or six-month periods ended December 31, 2012 or 2011, is as follows:

	As of and for the three months ended December 31,				As of and for the three months ended December 31,			
	2012		2011		2012		2011	
	Sales	Percent of Total	Accounts Receivable	Percent of Total	Sales	Percent of Total	Accounts Receivable	Percent of Total
Customer 1	\$ 1,136,000	38%	\$ 432,000	37%	\$ 880,000	7%	\$ 240,000	9%
Customer 2	\$ 372,000	13%	\$ 124,000	11%	\$ 1,906,000	16%	\$ 778,000	30%

As of and for the six months ended December 31,			
2012		2011	
Sales	Percent of Total	Sales	Percent of Total

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		Percent of Total	Accounts Receivable	Percent of Total		Percent of Total	Accounts Receivable	Percent of Total
Customer 1	\$ 3,072,000	48%	\$ 432,000	37%	\$ 2,541,000	21%	\$ 240,000	9%
Customer 2	\$ 490,000	8%	\$ 124,000	11%	\$ 4,294,000	36%	\$ 778,000	30%

In December 2009, Customer 1 (the Customer ), our then-largest customer, informed us that it was in the process of developing, and planned to eventually manufacture, its own surgical devices that were functionally comparable to the products the Company provided to the Customer at that time. Pro-Dex had been the exclusive manufacturer of these products

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since they were developed. Through May 2012, we provided the Customer with two products ( Product A and Product B ) and we continue to provide repair services for both products. Sales for each of these categories for the three and six months ended December 31, 2012 and 2011 were as follows:

	Three months ended December 31,	
	2012	2011
Product A	\$	\$ 157,000
Product B		1,340,000
Repairs	372,000	409,000
Total	\$ 372,000	\$ 1,906,000

  

	Six months ended December 31,	
	2012	2011
Product A	\$	\$ 950,000
Product B		2,531,000
Repairs	490,000	813,000
Total	\$ 490,000	\$ 4,294,000

In June 2011, the Customer informed us that its product development had progressed to the point at which it did not plan to place any new orders with us for these products beyond those orders already placed with delivery dates through May 2012, and we have received no such new orders.

In addition, the Customer indicated that it planned to limit repair requests from us to those Products A and B that are covered by our product warranty. Although we continue to receive out-of-warranty repair orders from the Customer, such repair revenue would decline to zero or a negligible amount should the Customer decide at any time in the future to cease placing new repair orders with us.

We continue to implement the steps of a strategic plan in response the loss of the Customer, the objectives of which are to identify and capture additional revenue opportunities and concurrently reduce operating costs not critical to revenue growth. There can be no assurance, however, as to either the timing or success of achieving these objectives, which, during any period not achieved, could cause us to experience a prolonged material and adverse impact on our business.

**NOTE 10. COMMITMENTS AND CONTINGENCIES****Change in Composition of our Board of Directors**

In June 2012, AO Partners Group, whose members own approximately 22% of our outstanding common stock, nominated a slate of three director nominees, Messrs. Nicholas J. Swenson, Raymond E. Cabillot and William J. Farrell III, (the AO Nominees ) to run in opposition to the slate of five director nominees placed into nomination by our then-incumbent Board of Directors (the Pro-Dex Nominees ). At its January 17, 2013 Annual Meeting, our shareholders elected the three AO Nominees and two Pro-Dex Nominees, Messrs. William L. Healey (an incumbent member of our Board of Directors) and David C. Hovda, to fill the five seats on our new Board of Directors. As a result, the new Board of Directors is composed of four new members and one continuing member. At its February 4, 2013 meeting, the Board of Directors elected Mr. Swenson as Chairman, Mr. Cabillot as Chair of the Compensation Committee and the Nominating and Governance Committee, and Mr. Hovda as Chair of the Audit Committee.

The degree of change in composition of our Board as described above constitutes a change of control as that term is defined in existing change of control agreements we previously entered into with members of senior management ( Change of Control Agreements ) and as defined in our Stock Option Plans. Although the change of control as defined in these instruments has had no impact on the accompanying consolidated financial statements, the potential effects of the change of control are as follows:

**Change of Control Agreements**

The Change of Control Agreements provide that, if the individual s employment with us involuntarily terminates (as such term is defined in the Change of Control Agreements) within 12 months after a change of control, the individual will receive, subject to signing a release of claims, (i) a lump sum amount equal to 30 weeks base compensation of the individual at the time of such termination and (ii) 100% Company-paid

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insurance coverage as provided to the individual immediately prior to his termination of employment for a period equal to the earlier of (i) 12 months following termination or (ii) until the individual becomes covered under another employer's insurance plan. In addition, the individual shall be entitled to receive bonus or compensation award payments, if any, in accordance with the terms of our incentive compensation plans in which the individual was an eligible participant at the time of the termination. We have such agreements with six members of senior management (including, but not limited to, our President and Chief Executive Officer and our Chief Financial Officer) whose annual base compensation aggregates \$1.1 million.

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### **Stock Option Plans**

In the event of a change of control, our Board has the discretion to accelerate the vesting of any outstanding options or shares of restricted stock held by employees. At its meeting on February 4, 2013, the Board did not take action to effect such acceleration. Vesting of outstanding options held by members of our Board would be automatically accelerated as a result of a change of control. However, at January 17, 2013, all outstanding options held by members of our Board were already fully vested under such options' terms.

### **Board Compensation**

The compensation plan for non-employee directors (the "directors' compensation plan") of the Board provides for the following:

An annual retainer of \$24,000 for each director;

An additional annual retainer of \$7,000 for the Board Chairman or Lead Director, and \$5,000 for each Board Committee Chair;

Fees ranging from \$500 to \$1,000 for participation in Board or Committee meetings in excess of six per year; and

An option grant under the Directors Plan (as defined in Note 8) for the purchase of (i) 15,000 shares of common stock upon the director's initial election or appointment to the Board, and (ii) 10,000 shares of common stock upon the director's re-election to the Board.

On February 4, 2013, Messrs. Swenson, Cabillot and Farrell each opted to waive (a) receipt of stock options they were otherwise entitled to receive upon their election to the Board at the January 17, 2013 Annual Meeting of our shareholders, and (b) any cash retainers or meeting fees in excess of \$200 per meeting and \$2,000 per year.

### **Legal Matters**

In February 2011, we became aware of a report entitled "Site Discovery Report, Southeast Santa Ana Project DTSC - Cypress Region," dated February 2010 (the "Report"), that was prepared by the Cypress regional office of the Cal/EPA Department of Toxic Substances Control ("DTSC") for Region 9 of the U.S. Environmental Protection Agency ("USEPA") under an agreement between the two agencies. The purpose of the Report was to identify sites within an area of southeast Santa Ana, California that may be sources of groundwater contamination previously detected in that area. The Report identified 25 sites, including our former Santa Ana site, for further screening by DTSC staff. DTSC has informed us that no further evaluation of our former site has taken place subsequent to the Report's issuance, and that no such evaluation is planned for fiscal year 2013. It is uncertain whether future developments, if any, from DTSC's screening process would have any application to our former site.

In general, 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.

### **NOTE 11. 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.



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*Real estate held for sale:* The land and building comprising this asset category are classified within Level 2 of the valuation hierarchy for purposes of evaluating carrying value.

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 its valuation methods are appropriate.

### **NOTE 12. SUBSEQUENT EVENTS**

We have evaluated events or transactions that occurred after the balance sheet date of December 31, 2012 and have identified no such events or transactions which required adjustment to, or disclosure in, these Condensed Consolidated Financial Statements other than as presented in such financial statements and the Notes thereto, including Note 6, Discontinued Operations, and Note 10, Commitments and Contingencies.

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

The following discussion and analysis provides information that management believes is relevant to an assessment and understanding of the results of operations and financial condition of Pro-Dex, Inc. ( Company , Pro-Dex , we , our or us ) for the three and six-month periods ended December 31, 2012 and 2011. This discussion should be read in conjunction with the Condensed 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.

Except for the historical information contained herein, the matters discussed in this report, including, but not limited to, discussions of our product development plans, business strategies and market factors influencing our results, are forward-looking statements that involve certain risks and uncertainties. Actual results may differ from those anticipated by us as a result of various factors, both foreseen and unforeseen, including, but not limited to, our ability to continue to develop new products and increase sales in markets characterized by rapid technological evolution, consolidation within our target marketplace and among our competitors, and competition from larger, better capitalized competitors. Many other economic, competitive, governmental and technological factors could impact our ability to achieve our goals. You are urged to review the risks, uncertainties and other cautionary language described in this report, as well as in our other public disclosures and reports filed with the Securities and Exchange Commission ( SEC ) from time to time, including, but not limited to, the risks, uncertainties and other cautionary language discussed in our Annual Report on Form 10-K, as amended, for our fiscal year ended June 30, 2012.

With operations in Irvine, California and Beaverton, Oregon, we provide products used in medical, research and industrial applications. Experience in surgical devices and multi-axis motion control applications allows us to develop products that require high precision in harsh environments.

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

On February 27, 2012, we completed the sale of our fractional horsepower motor product line, operating under the name Pro-Dex Astromec ( Astromec ) and located in Carson City, Nevada, to SL Montevideo Technology, Inc., a wholly owned subsidiary of SL Industries, Inc. The Astromec product line has been treated as a discontinued operation in the Condensed Consolidated Financial Statements and the Notes thereto included elsewhere in this report for all periods presented. The following discussion and analysis provides information solely with respect to our continuing operations, which excludes Astromec, unless otherwise indicated.

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 other SEC filings, are available free of charge through our website as soon as reasonably practicable after such reports are electronically filed with, or furnished to, the SEC. In addition, our Code of Ethics and other corporate governance documents may be found on our website at the Internet address set forth above. Our filings with the SEC may also be read and copied at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC at [www.sec.gov](http://www.sec.gov) and company specific information at [www.sec.gov/edgar/searchedgar/companysearch.html](http://www.sec.gov/edgar/searchedgar/companysearch.html).

### **Critical Accounting Estimates and Judgments**

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States ( GAAP ). The preparation of our financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosures. We base our estimates on historical experience and various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

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### **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 for the recognition of a sale have been satisfied.

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

### **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 year, 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) 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.

### **Accounts Receivable**

Trade receivables are stated at their original invoice amounts, less an allowance for portions of such amounts, the collection of which is believed to be doubtful. 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.

### **Long-lived Assets and Real Estate Held for Sale**

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

### **Stock-Based Compensation**

We recognize compensation expense for all share-based awards made to employees and directors by estimating the fair value of share-based awards at the grant date and recognizing compensation expense over the requisite service period.

For stock options, fair value is estimated 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 and projected employee stock option exercise behavior. We currently estimate stock price volatility based upon historical activity, with future volatility expected to approximate past volatility. The expected time to exercise is based on a simplified model of the vesting term of the option plus one-half the option life.

### **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 December 31, 2012 and June 30, 2012 consisted primarily of net operating loss and research and development tax credit carryovers, as well as basis differences related to intangible assets, accrued expenses and inventories.



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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 December 31, 2012 and June 30, 2012, we maintained a valuation allowance against the entire balance of our deferred tax assets, net of deferred tax liabilities.

**Description of Business**

The majority of our revenue is derived from designing, developing and manufacturing surgical devices for the medical device 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:

<b>Customer type</b>	<b>Three months ended December 31,</b>				<b>Six months ended December 31,</b>			
	<b>2012</b>		<b>2011</b>		<b>2012</b>		<b>2011</b>	
	<b>(Dollars in thousands)</b>				<b>(Dollars in thousands)</b>			
Medical	\$ 1,925	64%	\$ 2,955	74%	\$ 4,294	66%	\$ 7,076	78%
Industrial	576	19%	772	19%	1,337	21%	1,415	16%
Dental	279	9%	209	5%	485	7%	414	5%
Government and other	227	8%	81	2%	352	6%	157	1%
Total sales	\$ 3,007	100%	\$ 4,017	100%	\$ 6,468	100%	\$ 9,062	100%

Our medical device products utilize proprietary designs developed by us under exclusive design and supply agreements and are manufactured in our Irvine, California facility, as are our dental products, which are sold primarily to original equipment manufacturers and dental product distributors. We design and manufacture embedded multi-axis motion controllers in our facility in Beaverton, Oregon.

At December 31, 2012, we had a backlog of \$8.9 million. We may experience variability in our new order bookings due to various reasons, including, but not limited to, the timing of major new product launches and customer planned inventory builds. However, we do not typically experience seasonal fluctuations in our shipments and revenues.

**RESULTS OF OPERATIONS****Comparison of the three-months ended December 31, 2012 and 2011**

The following table sets forth financial data and the percentage of net sales of our operating results:

	<b>Three Months Ended December 31,</b>			
	<b>2012</b>		<b>2011</b>	
	<b>Dollars in thousands</b>			
Net sales	\$ 3,007	100%	\$ 4,017	100%
Cost of sales	1,974	66%	2,770	69%
Gross profit	1,033	34%	1,247	31%
Selling expenses	322	11%	369	9%
General and administrative expenses	627	21%	688	17%
Research and development costs	464	15%	508	13%
Loss from continuing operations before items below	(380)	-13%	(318)	-8%
Interest expense and other, net			(10)	

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Loss before provision for (benefit from) income taxes	(380)	-13%	(328)	-8%
Provision for (benefit from) income taxes	(16)	-1%	1	
Loss from continuing operations	(364)	-12%	(329)	-8%
Income from discontinued operations	16	1%	37	1%
Net loss	\$ (348)	-11%	\$ (292)	-7%

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Net sales for the three months ended December 31, 2012 decreased \$1.0 million, or 25%, to \$3.0 million from \$4.0 million for the three months ended December 31, 2011. Medical device sales decreased \$1.0 million, or 35%, due primarily to a decrease of \$1.5 million in sales to our former largest medical device customer, which was partially offset by increased sales of \$256,000 and \$247,000 to our current largest medical device customer and other medical device customers, respectively. Excluding medical device sales, our Irvine and Beaverton locations generated a net increase in sales of \$306,000 and a net decrease in sales of \$285,000 respectively, during the three months ended December 31 2012 as compared to the same period in 2011.

Gross profit for the three months ended December 31, 2012 decreased \$214,000, or 18%, compared to the corresponding period in 2011. Of this decrease, \$433,000 related to the decrease in sales volume discussed above, offset by related reduced warranty expense of \$194,000. As a percentage of sales, gross margin increased to 34% for the three months ended December 31, 2012 from 31% for the corresponding period in 2011, attributable primarily to the reduced warranty expense and increased manufacturing efficiencies, partially offset by unfavorable changes in product mix.

Selling expenses decreased \$47,000, or 13%, to \$322,000 for the three months ended December 31, 2012, from \$369,000 for the corresponding period in 2011. This decrease is attributable primarily to decreases in advertising and market research expenses of \$73,000, offset by an increase in compensation expenses of \$28,000.

General and administrative expenses decreased \$61,000, or 9%, to \$627,000 for the three months ended December 31, 2012, from \$688,000 for the corresponding period in 2011, due primarily to decreases in compensation expense of \$97,000, offset by increases in legal expenses of \$41,000 primarily incurred in connection with the contested election of directors for our 2012 annual meeting of shareholders and in connection with increased activity in protection of our intellectual property.

Research and development costs decreased \$44,000, or 9%, to \$464,000 for the three months ended December 31, 2012, from \$508,000 for the three months ended December 31, 2011, due primarily to the utilization of engineering resources in contractual revenue-producing activities.

Net interest expense for the three months ended December 31, 2012 was nil, compared to \$10,000 for the three months ended December 31, 2011. This decrease was due to the repayment, in September 2012, of the then-entire outstanding balance of the Company's bank term loan.

The benefit from income taxes for the three months ended December 31, 2012 resulted primarily from benefits derived from the loss from continuing operations. The provision for income taxes for the three months ended December 31, 2011 consisted primarily of state franchise taxes. Effective tax rates in both periods were less than 1% 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 Condensed Consolidated Financial Statements contained elsewhere in this report.)

As a result of the foregoing, loss from continuing operations for the three months ended December 31, 2012 was \$364,000, as compared to \$329,000 for the three months ended December 31, 2011.

**Table of Contents****Comparison of the six-month periods ended December 31, 2012 and 2011**

The following table sets forth financial data and the percentage of net sales of our operating results:

	For the six months ended December 31,			
	2012		2011	
	Dollars in thousands			
Net sales	\$ 6,468	100%	\$ 9,062	100%
Cost of sales	4,199	65%	5,707	63%
Gross profit	2,269	35%	3,355	37%
Selling expenses	596	9%	743	8%
General and administrative expenses	1,234	19%	1,504	17%
Research and development costs	870	13%	1,069	12%
Income (loss) from continuing operations before items below	(431)	-6%	39	
Net interest and other expense	(6)		(20)	
Income (loss) before provision for (benefit from) income taxes	(437)	-6%	19	
Provision for (benefit from) income taxes	(19)		2	
Income (loss) from continuing operations	(418)	-6%	17	
Income from discontinued operations	53	1%	137	2%
Net income (loss)	\$ (365)	-5%	\$ 154	2%

Net sales for the six months ended December 31, 2012 decreased \$2.6 million, or 29%, to \$6.5 million from \$9.1 million for the six months ended December 31, 2011. Contributing to this decrease was (a) a reduction, amounting to \$3.8 million, in sales to our former largest medical device customer, offset by an increase, amounting to \$531,000, in sales to our current largest medical device customer, (b) a net increase, amounting to \$491,000, in sales to other medical device customers, and (c) a net increase, amounting to \$188,000, in sales of other product lines.

For the six months ended December 31, 2012, gross profit decreased \$1.1 million to \$2.3 million, compared to \$3.4 million for the corresponding period in 2011, due to the decrease in sales volume described above. As a percentage of sales, gross margin decreased to 35% for the six months ended December 31, 2012 from 37% for the corresponding period in 2011. This decrease resulted primarily from reduced manufacturing efficiencies and unfavorable changes in product mix, partially offset by a reduction in warranty costs.

Selling expenses decreased \$147,000, or 20%, to \$596,000 for the six months ended December 31, 2012, from \$743,000 for the corresponding period in 2011. This decrease is attributable primarily to decreases in advertising and market research expenses of \$132,000 and to travel and tradeshow expenses of \$17,000 during the six months ended December 31, 2012 relative to the corresponding period in 2011.

General and administrative expenses decreased \$270,000, or 18%, to \$1,234,000 for the six months ended December 31, 2012, from \$1,504,000 for the corresponding period in 2011, due primarily to decreases in 2012 related to employee training and compensation expenses of \$236,000 and a decrease in legal expenses of \$36,000 in the six-month period ended December 31, 2012 from the corresponding period in 2011.

Research and development costs, which include costs related to development of new products and enhancements to existing products, decreased \$199,000, or 19%, to \$870,000 for the six months ended December 31, 2012, from \$1,069,000 for the six months ended December 31, 2011 due primarily to the utilization of engineering resources in contractual revenue-producing activities and reductions in employee compensation of \$158,000 and \$44,000, respectively.

Net interest expense for the six months ended December 31, 2012 was \$6,000 compared to \$20,000 for the six months ended December 31, 2011. This decrease was due to the repayment, in September 2012, of the then-entire outstanding balance of the Company's bank term loan.



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The benefit from income taxes for the six months ended December 31, 2012 resulted primarily from benefits derived from the loss from continuing operations. The provision for income taxes for the six months ended December 31, 2011 consisted primarily of state franchise taxes. Effective tax rates in both periods were less than 1% 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 Condensed Consolidated Financial Statements contained elsewhere in this report.)

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As a result of the foregoing, loss from continuing operations for the six months ended December 31, 2012 was \$418,000 as compared to income from continuing operations of \$17,000 for the six months ended December 31, 2011.

**Liquidity and Capital Resources**

The following table presents selected financial information as of December 31, 2012 and June 30, 2012:

	December 31, 2012	June 30, 2012
Cash and cash equivalents	\$ 2,549,000	\$ 4,112,000
Working capital	\$ 6,614,000	\$ 6,618,000
Cash and cash equivalents, net of bank debt	\$ 2,549,000	\$ 3,338,000

Net cash used in operating activities during the six months ended December 31, 2012 amounted to \$791,000. Our operations, excluding the balance sheet changes discussed below in this paragraph, used cash amounting to \$5,000. Uses of cash arose primarily from (a) a build-up of inventory of \$724,000 related primarily to the purchase of components required to fulfill firm customer purchase orders in backlog as well as repair and warranty orders, and to build our stock of components related to certain of our products with the objective of shortening lead times when forecasted purchase orders are received, (b) a reduction from June 30, 2012 in accounts payable and accrued liabilities aggregating \$476,000, and (c) an increase of \$65,000 in prepaid expenses, primarily relating to annual insurance policy renewals in October 2012. Partially offsetting these cash uses were (a) a decrease in accounts receivable and other current receivables of \$440,000, due primarily to the lower sales volume, and (b) a reduction in income taxes receivable of \$39,000, representing a refund of taxes paid in the prior year.

Net cash used in investing activities for the six months ended December 31, 2012 and 2011 was \$48,000 and \$237,000, respectively, and consisted primarily of capital expenditures for manufacturing equipment.

Net cash used in financing activities for the six months ended December 31, 2012 was \$724,000 as compared to \$179,000 in the corresponding 2011 period. This increase reflects 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 our discussion under the caption "Changes in Bank Debt and Credit Facilities" below).

We believe that existing cash balances and cash flows from operations will be sufficient to fund operations for the next twelve months.

**Reduction in Large Customer Orders**

In December 2009, our then-largest customer informed us that it was in the process of developing, and planned to eventually manufacture, its own surgical devices that were functionally comparable to the products we provided to the customer at that time. We had been the exclusive manufacturer of these products since they were developed. The resulting reduction in orders from our former largest customer and its expected future impact on our business is more fully described in Note 9 of Notes to Condensed Consolidated Financial Statements contained elsewhere in this report.

We continue to implement the steps of a strategic plan in response the loss of the customer, the objectives of which are to identify and capture additional revenue opportunities and concurrently reduce operating costs not critical to revenue growth. There can be no assurance, however, as to either the timing or success of achieving these objectives, which, during any period not achieved, could cause us to experience a prolonged material and adverse impact on our business.

**Changes in Bank Debt and Credit Facilities**

As more fully described in Note 5 of Notes to Condensed Consolidated Financial Statements contained elsewhere in this report, on February 4, 2011, we entered into a credit facility agreement with Union Bank that provided for (a) a revolving credit line of up to \$1.5 million, (b) a non-revolving credit line of up to \$350,000 for the purchase of equipment, and (c) a term loan of \$1.25 million.

The credit facility agreements contained various covenants, including certain covenants measured annually based on fiscal year results, concerning our financial performance. At June 30, 2012, we were in violation of profitability-based covenants, for which the bank had the right to declare us in default of the bank credit facility agreements and the entire amount owing under the facility, consisting of the term loan, to become immediately due and payable.

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On August 30, 2012, we notified the bank of our intent to terminate the credit facility agreements and repay the term loan in full, on or before September 30, 2012. By letter to us dated September 4, 2012, the bank waived, through October 1, 2012, the rights it otherwise would have had pursuant to the covenant violations described above. In conformity with the correspondence described in this paragraph, on September 24, 2012, we repaid the entire principal balance of the term loan, amounting to \$685,000 and the credit facility agreements were terminated.

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 its 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 our directors compensation plan, and (b) any cash retainers or meeting fees they were otherwise entitled to receive under the provisions of our directors compensation plan in excess of \$200 per meeting and \$2,000 per year. (See Note 10 of Notes to Condensed Consolidated Financial Statements.)

Assuming their continued service as directors through the date of the 2013 Annual Meeting of Shareholders, we believe the revised director compensation agreed to by Messrs. Swenson, Cabillot and Farrell will result in (a) reduced non-cash compensation expense in the six-month period ending June 30, 2013 of approximately \$55,000 as a result of the foregone options, and (b) reduced cash compensation expense of approximately \$70,000 through the remainder of calendar year 2013, relative to what such expenses would have been without the waivers.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Not applicable.

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**Item 4. Controls and Procedures**  
**Evaluation of Disclosure Controls and Procedures**

Our Chief Executive Officer and Chief Financial Officer (the principal executive officer and principal financial officer, respectively) conducted an evaluation of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended ( Exchange Act )). The term disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act means controls and other procedures of a company that are designed to ensure that information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures also include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate, to allow timely decisions regarding required disclosure. Based on that evaluation as of December 31, 2012, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures are effective.

**Changes in Internal Control over Financial Reporting**

During the three months ended December 31, 2012, there were no changes in our 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, our internal controls over financial reporting.

**Inherent Limitations on the Effectiveness of Controls**

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.

**PART II**
**OTHER INFORMATION**
**Item 1. Legal Proceedings.**

In February 2011, we became aware of a report entitled Site Discovery Report, Southeast Santa Ana Project DTSC Cypress Region, dated February 2010 (the Report ), that was prepared by the Cypress regional office of the Cal/EPA Department of Toxic Substances Control ( DTSC ) for Region 9 of the U.S. Environmental Protection Agency ( USEPA ) under an agreement between the two agencies. The purpose of the Report was to identify sites within an area of southeast Santa Ana, California that may be sources of groundwater contamination previously detected in that area. The Report identified 25 sites, including our former Santa Ana site, for further screening by DTSC staff. DTSC has informed us that no further evaluation of our former site has taken place subsequent to the Report's issuance, and that no such evaluation is planned for fiscal year 2013. It is uncertain whether future developments, if any, from DTSC's screening process would have any application to our former site.

In general, 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.

**Item 1A. Risk Factors.**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K, as amended, for our fiscal year ended June 30, 2012 and in our subsequent quarterly reports on Form 10-Q. The risks discussed in our Annual Report on Form 10-K, as amended, and in our subsequent quarterly reports on Form 10-Q could materially affect our business, financial condition and future results. The risks described in our Annual Report on Form 10-K, as amended, and in our subsequent quarterly reports on Form 10-Q are not the only risks facing us. Additional 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.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**  
None.

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**Item 3. Defaults Upon Senior Securities.**

None.

**Item 4. Mine Safety Disclosures.**

Not applicable.

**Item 5. Other Information.**

None.

**Item 6. Exhibits.**

**Exhibits:**

10.1*	Waiver of Director Compensation of Nick Swenson, dated February 4, 2013.
10.2*	Waiver of Director Compensation of Ray Cabillot, dated February 4, 2013.
10.3*	Waiver of Director Compensation of William Farrell, dated February 4, 2013.
31.1	Certification of Chief Executive Officer Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of 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.DEF**	XBRL Taxonomy Extension Definition Linkbase
101.LAB**	XBRL Taxonomy Extension Label Linkbase
101.PRE**	XBRL Taxonomy Extension Presentation Linkbase

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

\*\* 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.

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SIGNATURES

In accordance with 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.

Date: February 13, 2013

Date: February 13, 2013

PRO-DEX INC.

By: / s / Michael J. Berthelot

PRO-DEX INC.

By: / s / Harold A. Hurwitz

Michael J. Berthelot

Chief Executive Officer

Harold A. Hurwitz

Secretary and Chief Financial Officer

(Principal Executive Officer)

(Principal Financial and Accounting Officer)