

PRO DEX INC  
Form 10KSB  
September 28, 2004

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-KSB**

**ANNUAL Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.**

**For the fiscal year ended June 30, 2004**

**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**  
**(State or Other Jurisdiction of  
Incorporation or Organization)**

**84-1261240**  
**(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:**

<b><u>Title of each class</u></b>	<b><u>Name of each exchange on which registered</u></b>
<b>None</b>	<b>None</b>

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

**Common stock, no par value**  
**(Title of class)**

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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  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.

Issuer's revenues for its most recent fiscal year were \$14,200,000.

The aggregate market value of the voting stock held by non-affiliates computed by reference to the closing price as of September 17, 2004 was \$22,031,000. 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: 8,862,012 shares of Common Stock, no par value, as of September 17, 2004.

DOCUMENTS INCORPORATED BY REFERENCE: Part III incorporates by reference certain information from the registrant's definitive proxy statement (the "Proxy Statement") for the 2004 Annual Meeting of Shareholders. Certain exhibits are set forth in the Exhibit Index. The Exhibit Index begins on sequentially numbered page 40.

Transitional Small Business Disclosure Format: Yes  No

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**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 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.

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## **Item 1. Business**

### **Company Overview**

Pro-Dex, Inc. ("Pro-Dex" or the "Company") is a Colorado corporation, organized in 1978, currently conducting business in two locations. In the fiscal year ended June 30, 2004 ("2004"), the Company eliminated its "holding company" structure and terminated the separate legal status of the Company's 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, the Company no longer operates as a holding company but as one unified business operating in two locations; Santa Ana and Beaverton. The operating activities and focus of each location will become further integrated into one a company operating structure, with the historical legal separations and associated overhead costs removed. There remain two reportable segments within Pro-Dex: Rotary Drives (formerly Micro Motors) and Motion Control (formerly Oregon Micro Systems). The Company continues to serve the medical, dental, semi-conductor and scientific research market segments, designing and manufacturing electric, air, and battery powered rotary drive systems, hand-held rotary instruments, miniature pneumatic motors, as well as embedded multi-axis motion controllers used to regulate the motion of servo and stepper motors.

The Company's principal headquarters are located at 151 E. Columbine Avenue, Santa Ana, California 92707 and its phone number is 714-241-4411. The Company's Internet address is [www.pro-dex.com](http://www.pro-dex.com). The Company's 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 the Company's website as soon as reasonably practicable after such reports are electronically filed with, or furnished to, the SEC. In addition the Company's Code of Ethics may be found on its website at the Internet address set forth above. The Company's 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 <http://www.sec.gov>.

### **Description of Business**

The majority of the Company's 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. The Company also distributes its own line of pneumatic and electric dental hand pieces sold under the Micro Motors name utilizing a network of independent sales representatives across North America. A large part of the revenue growth of the Company has been driven by developing and selling numerous private label rotary drive systems for use in dental, cranial, spinal, arthroscopic and orthopedic surgery. A successful strategy change is evidenced in the Company's product sales mix which has shifted its focus to the development and exclusive supply of rotary drive systems for strategic partners in the medical, dental and industrial segments of the commercial marketplace. This new approach to the market has proved to be effective in generating new revenue streams with gross margins significantly higher than the Company's historical dental business. Other revenue sources include designing and manufacturing miniature pneumatic motors for industrial applications in the automotive, aerospace, apparel and entertainment industries.

Company funded research and development supports the development of rotary drive platforms. The Company then seeks customer-funded projects to customize these platforms to specific customer requirements. Company funded research and development projects generally are 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, 2004,

\$1,790,000 was expensed; an increase of \$333,000 from the \$1,457,000 expensed in the year ended June 30, 2003.

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In customer funded development projects, costs are capitalized and recognized as a cost of goods sold as specific deliverables within the development contracts are made, matching the costs to the revenue and reducing the performance and collection risk to the Company. In the year ended June 30, 2004, \$221,000 was recognized as cost of goods sold, and was \$442,000 recognized as cost of goods sold in the year ended June 30, 2003.

Customer funded research and development provided \$426,000 in revenue in the year ended June 30, 2004, and \$892,000 in revenue in the year ended June 30, 2003. The results of the development work are intended to provide the Company with long-term exclusive manufacturing agreements and provide the customer with 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:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Dental	32%	43%	54%
Medical	41%	28%	17%
Semi-Conductor and industrial	18%	19%	19%
Government research and other	9%	10%	10%

The Company's dental products are sold to original equipment manufacturers and dental product distributors. An independent dealer network was engaged in 2003 to market its own branded line of dental products in a more effective manner. The medical products sales represent the manufacture of proprietary designs developed by the Company under exclusive design and supply agreements. The Company designs and manufactures embedded multi-axis motion controllers used to regulate the motion of servo and stepper motors, predominantly for the semiconductor and medical analysis equipment industries. The controllers support the platforms for PCI, VME, ISA, and cPCI busses as well as standalone requirements. Other products sold by the Company include motors, drivers, cables, software and a variety of accessories to meet most embedded motion control requirements; as well as pneumatic motors for industrial applications that are marketed directly to end-users and through industrial supply distributors. The increase in the percent 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 the Company's research and development efforts away from dental products and toward the Company's capabilities in the medical product market.

Of Pro-Dex sales in 2004, over 16% were shipments of products developed in the last 12 months and 31% were shipments of products developed in the last 24 months as a result of Research and Development contracts with new or existing customers.

In 2004, 20 customers accounted for 72% of Pro-Dex sales, up from 69% in 2003. In 2004, Pro-Dex's three largest customers accounted for 32% of such sales with one customer accounting for over 17% of sales. No other customer accounted for over 10% of sales. Pro-Dex's larger customers include Smith and Nephew, Medtronics, Sullivan Schein, Karl Storz, Curozone, Applied Materials and Pemstar. In some cases disclosure of other larger customer names is prohibited by confidentiality agreements with such entities. Sales to medical and industrial customers tend to be to relatively larger companies, as compared to customers for dental products which are typically to smaller companies. Pro-Dex has no plans to discontinue the sales relationships with its existing customers, and has no knowledge that these customers have any plans to discontinue their relationships with Pro-Dex, although the relationships may change over time.

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

The Company's commitment to quality manufacturing is demonstrated by its many independently verified certifications for maintaining quality processes and products. The Company holds the following certifications: ISO 9001:2000, ISO 13485 revised 1998, and Medical Device Directive 93\42\EEC Annex II company.

At the present time, the Company is generally able to fill orders within sixty (60) days. At June 30, 2004, the Company had a backlog, including orders for delivery beyond 60 days, of \$5.1 million compared with a backlog of \$5.4 million at June 30, 2003. The Company expects to fill all of its future orders during the current fiscal year. Pro-Dex does not typically experience seasonal fluctuations in its orders. The decreased backlog is due to the Company transitioning to a royalty payment agreement from a manufacturing agreement for its HealOzone product and the timing of long-term blanket purchase orders. Although Pro-Dex may experience seasonal fluctuations in its new order bookings due to the timing of major medical, dental and industrial shows and events, it does not typically experience seasonal fluctuations in its order shipments.

The Company distributes its products directly to original equipment manufacturers and through a network of high technology distributors within the United States. 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, the Company's executive operations in Colorado were consolidated into the facilities in Santa Ana, California. This and other efforts to streamline the Company's structure and reduce corporate overhead saved the Company approximately \$980,000 in fiscal year 2003 as compared to fiscal year 2002, primarily in reduced lease costs, eliminated management salary costs and reduced consulting fees. Corporate costs were reduced an additional \$133,000 in 2004 as compared to 2003 as management salary costs were eliminated and consulting costs were reduced for the second year.

## **Competition**

The markets for products in the healthcare and semiconductor industries are intensely competitive, and the Company faces significant competition from a number of different sources. Several of the Company's competitors have significantly greater name recognition as well as substantially greater financial, technical, product development and marketing resources than the Company.

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

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## **Research and Development**

The Company conducts company-wide and project specific research and development programs. The Company considers these product development programs to be of importance in both maintaining and improving its market position. The net amounts spent on research and development activities in 2004 and 2003 were approximately \$1.79 million and \$1.46 million, respectively. The Company's research and development effort involves the design and manufacture of products that perform specific applications for its customers. During the year ended June 30, 2004, the Company continued to successfully target its research and development expenses to expanding its customer base in the medical device industry and in general technical advances, along with continued enhancements of current product lines. The Company was also successful in increasing the amounts of its research and development costs recovered by billing its customers for non-recurring engineering expenses. The fees received for non-recurring engineering expenses do not represent a significant portion of the Company's revenue.

## **Employees**

At June 30, 2004, the Company had 82 full-time and 1 part-time employees compared to 85 full-time and 1 part-time employees at June 30, 2003. As of June 30, 2004, there were 68 persons employed at the Santa Ana location and 15 persons employed at the Beaverton location compared to 71 persons employed at the Santa Ana location and 15 persons employed at the Beaverton location at June 30, 2003.

None of the Company's employees are a party to any collective bargaining agreements with the Company. The Company considers its relations with its employees to be good.

## **Government Regulations**

The Company's 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 the management of each of the Company's operating subsidiaries makes every effort to maintain full compliance with all applicable laws and regulations, the Company is unable to eliminate an ongoing risk that one or more of its 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 the Company's business. Further, even if the Company is subsequently determined to have fully complied with applicable law or regulation, its costs to achieve such a determination and the intervening loss of business could adversely affect or even terminate a portion of the Company's business. Further, a change in such laws or regulations at any time may have an adverse effect on the Company's operations. Notwithstanding the risks inherent in the Company's business sectors, management believes that the Company's operations are in compliance with applicable laws and regulations.

The FDA regulates Pro-Dex's dental and medical handpieces as Class 1, Class 2 and Class 3 medical devices. The FDA has broad enforcement powers to recall and prohibit the sale of products which 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 the Company's products or processes. Nevertheless, as is common in the industry, certain of Pro-Dex's products and processes have been the subject of routine governmental reviews and investigations. While the Company's management is confident that Pro-Dex's products and processes fully comply with applicable laws and regulations, the Company is unable to predict the outcome of any such investigation or review, pending its completion.

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Management believes that Pro-Dex's 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. Although the semiconductor and computer chip industries are significantly impacted by EPA regulations applicable to the processes and materials used in production of computer chips and computer chip components, the Company's management has undertaken measures, where possible, to reduce the Company's exposure to the risk of non-compliance. Most significantly, Pro-Dex acquires pre-manufactured printed circuit boards as platforms upon which to place its technology. While the Company's management is confident that its products and processes fully comply with applicable laws and regulations, the Company is unable to predict the outcome of any investigation or review which may in the future be undertaken respecting its products or processes.

Management believes that Pro-Dex follows Good Manufacturing Practices for all of its products at each of its locations.

### **Patents, Trademarks, and Licensing Agreements**

The Company holds patents relating to multi-axis motion controllers and its miniature pneumatic motor products. Patents held by the Company have varying expiration dates, beginning in 2005. The expiration of the patents is not expected to cause any change in the Company's revenue generating operations.

The Company conducted a limited review of the patents acquired in connection with the 1995 OMS and Micro Motors acquisitions and believes that the use of such patent is neither infringed upon by any third party, nor infringes on any prior art of any third party. The Company is unable to assess the validity, scope, or defensibility of its patents, and any challenge to or claim of infringement relating to the Company's patents could materially and adversely affect the Company's 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 the Company's revenue generating operations.

The Company has certain trademarks relating to its miniature pneumatic motor products, including Dynatorq<sup>TM</sup>, Dynasurg<sup>TM</sup>, and Micro Handpiece<sup>TM</sup>. The Company has filed for federal trademark protection for OMS-EZ<sup>TM</sup> and Canaligator<sup>TM</sup>.

The Company has not entered into any licensing or franchising agreements for revenue generating purposes.

### **Funds Held in Escrow, Business Divestitures and Discontinued Operations**

On June 12, 2001, the Company sold substantially all of the assets of its wholly owned subsidiaries, Biotrol International, Inc. and Challenge Products, Inc. to Young Colorado, LLC ("Young"), for a purchase price of \$9 million. The assets sold comprised the Company's line of infection control and preventive chemical products for the dental industry. The Company received \$688,000 of the remaining escrow balance of \$790,000 in the quarter ending September 30, 2002, and the final \$122,000 (completing the distribution of funds in escrow) was received by October 2002, resulting in no additional gain or loss.

During the year ended June 30, 2002, the Company received indemnification notices from Young, to recover alleged losses and costs as they are incurred for certain alleged breaches of representations and warranties contained in the Young Asset Purchase Agreement related to compliance issues with the Food, Drug, and Cosmetic Act ("FDCA"), Federal Insecticide, Fungicide and Rodenticide Act ("FIFRA"), and other related laws. In February 2002, the Company settled a complaint with the EPA set forth in Young's indemnification notice for alleged violations of FIFRA. Pursuant to the settlement, the Company agreed to pay \$150,000 to the EPA, over a 15-month period, commencing March 2002. The full \$150,000 settlement was paid by April 30, 2003, leaving in managements' opinion, no additional liability under either Act.

## **Risk Factors**

### **Competition**

The markets for healthcare and semiconductor industries are intensely competitive, and the Company faces significant competition from a number of different sources. Several of the Company's competitors have significantly greater name recognition as well as substantially greater financial, technical, product development and marketing resources than the Company.

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

### **Fluctuation in Quarterly Operating Results**

The Company's 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 the Company or its competitors; the timing of new product announcements and product introductions by the Company or its competitors; the financial stability of major customers; the Company's success in expanding its sales and marketing programs; deferrals of customer orders in anticipation of new products; changes in Company strategy; personnel changes; and general market/economic factors.

Because a significant percentage of the Company's 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, the Company believes that interim period-to-period comparisons of its results of operations are not necessarily meaningful and should not be relied upon as indications of future performance. Further, the Company's 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) the Company's operating results may be below the expectations of public market analysts and investors. In such event, the price of the Company's Common Stock would likely be materially adversely affected.

### **Dependence on Principal Product and New Product Development**

The Company currently derives a substantial part of its net revenues from sales of its core healthcare and motion control products and services. The Company believes that a primary factor in the market acceptance of its product and services is the value that is created for its customers by those products and services. The Company's future financial performance will depend in large part on the Company's ability to continue to meet the increasingly sophisticated needs of its customers through the timely development, successful introduction and implementation of new and enhanced products and services. The Company has historically expended a significant percentage of its net revenues on product development and believes that significant continued product development efforts will be required to sustain the Company's growth. Continued investment in the Company's sales and marketing efforts will also be required to support future growth.

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

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## **Technological Change**

The healthcare and semiconductor 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 the Company will be successful in developing and marketing new products that respond to technological changes or evolving industry standards.

New product development depends upon significant research and development expenditures that depend ultimately upon sales growth. Any significant decrease in revenues or research funding could impair the Company's ability to respond to technological advances in the marketplace and to remain competitive. If the Company is 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, the Company's business, results of operations and financial condition may be materially adversely affected.

In response to increasing market demand, the Company is currently developing new products. There can be no assurance that the Company 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 introduction of competing products. Any such failure or delay could adversely affect the Company's competitive position or could make the Company's current products obsolete.

## **Litigation**

The Company continually faces 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 the Company might incur in connection with such litigation. The uncertainty associated with potential litigation may have an adverse impact on the Company's business. In particular, such litigation could impair the Company's relationships with existing customers and its 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 the Company's business, results of operations and financial condition. Such litigation may also have the effect of discouraging potential acquirers from bidding for the Company or reducing the consideration such acquirers would otherwise be willing to pay in connection with an acquisition.

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

## **Proprietary Technology**

The Company is dependent on the maintenance and protection of its intellectual property and relies on exclusive development and supply agreements, confidentiality procedures, and employee nondisclosure agreements to protect its intellectual property.

There can be no assurance that the legal protections and precautions taken by the Company will be adequate to prevent misappropriation of the Company's technology or that competitors will not independently develop technologies equivalent or superior to the Company's. Further, the laws of some foreign countries do not protect the Company's 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.

The Company does not believe that its 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 the

Company with respect to its current or future products or that any such assertion will not require the Company to enter into a license agreement or royalty arrangement with the party asserting the claim.

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### **Ability to Manage Growth**

The Company has in the past experienced periods of growth that have placed, and may continue to place, a significant strain on the Company's resources. The Company also anticipates expanding its overall development, marketing, sales, management and training capacity as market demand requires. In the event the Company is 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, the Company's ability to manage future increases, if any, in the scope of its operations or personnel will depend on significant expansion of its research and development, marketing and sales, management, and administrative and financial capabilities. The failure of the Company's management to effectively manage expansion in its business could have a material adverse effect on the Company's business, results of operations and financial condition.

### **Dependence Upon Key Personnel**

The Company's future performance also depends in significant part upon the continued service of its key technical and senior management personnel, many of who have been with the Company for a significant period of time. The Company does not maintain key man life insurance on any of its employees. Because the Company has a relatively small number of employees when compared to other leading companies in the same industry, its dependence on maintaining its relationship with key employees is particularly significant. The Company is also dependent on its ability to attract and retain high quality personnel, particularly in the areas of product development and operations management.

A high level of employee mobility and the aggressive recruiting of skilled personnel characterize the healthcare and semiconductor industries. There can be no assurance that the Company's current employees will continue to work for the Company. Loss of services of key employees could have a material adverse effect on the Company's business, results of operations and financial condition. Furthermore, the Company 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**

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

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

### **Marketplace Delisting**

In June 2002, the Company received a notice from NASDAQ indicating that unless its stock price maintained a \$1.00 per share closing bid price for ten consecutive trading sessions, the Company's stock would be delisted on December

3, 2002. As the Company maintained \$5,000,000 of stockholders' equity, meeting one of the qualifications to remain listed, the Company received notice in December 2002 that the delisting date was extended for 180 days. On March 24, 2003 the SEC approved a NASDAQ marketplace rule change that would extend the delisting date an additional 90 days or until September 2, 2003 contingent upon the Company continuing to meet the qualifications noted above. On June 19, 2003, the Company received notice from NASDAQ indicating that the stock price had maintained a closing bid price of over \$1.00 for at least 10 consecutive trading days and had regained compliance with the listing requirements. There is no assurance that the Company's shares will maintain a sufficiently high price to eliminate future delisting notices and subsequent delisting.

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**Item 2. Properties**

The Company's executive offices and Santa Ana manufacturing facility are located at 151 East Columbine Avenue, Santa Ana, California 92707. The Company leases the 18,000 square foot facility from an unrelated third party at a base monthly lease rate of \$13,000 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.

The Company's Beaverton offices and manufacturing facilities are 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 \$9,100 through October 2007. The building is a one-story suite in a 15-year-old industrial office complex and in good condition.

The Company's management believes that the monthly rental rates are comparable to rents charged for comparable properties in the market area. The Company believes that the current facilities are adequate for the expected needs of the Company. The Company requires full compliance by the lessor with applicable state and EPA environmental standards at each facility.

**Item 3. Legal Proceedings**

The manufacture and distribution of certain products by the Company involves a risk of legal action, and, from time to time, the Company being named as a defendant in lawsuits. While the Company's 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 the Company may not ultimately incur liability or that such liability will not be material and adverse.

The Company is a party to various legal proceedings incidental to its business, none of which are considered by the Company to be material at this time.

**Item 4. Submission of Matters to a Vote of Security Holders During the Year Ended June 30, 2004**

No matter was submitted to a vote of the Company's shareholders during the fourth quarter ended June 30, 2004.

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

The Company's 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.

<b><u>Quarter Ended</u></b>	<b><u>High</u></b>	<b><u>Low</u></b>
September 30, 2002	0.70	0.34
December 31, 2002	0.69	0.38
March 31, 2003	0.76	0.47
June 30, 2003	1.32	0.47
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

On September 17, 2004, the last sale price of the common stock as reported by NASDAQ was \$3.16 per share.

In June 2002, the Company received a notice from NASDAQ indicating that unless its stock price maintained a \$1.00 per share closing bid price for ten consecutive trading sessions, the Company's stock would be delisted on December 3, 2002. As the Company maintained \$5,000,000 of stockholders' equity, meeting one of the qualifications to remain listed, the Company received notice in December 2002 that the delisting date was extended for 180 days. On March 24, 2003 the SEC approved a NASDAQ marketplace rule change that would extend the delisting date an additional 90 days or until September 2, 2003 contingent upon the Company continuing to meet the qualifications noted above. On June 19, 2003, the Company received a notice from NASDAQ indicating that the Company's stock price had maintained a closing bid price of over \$1.00 for at least 10 consecutive trading days and had regained compliance with the listing requirements. There is no assurance that the Company's shares will maintain a sufficiently high price to eliminate future delisting notices and subsequent delisting.

At June 30, 2004, there were approximately 310 holders of record of the Company's common stock. This number does not include beneficial owners including holders whose shares are held in nominee or "street" name.

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

**Equity Compensation Plan Information**

Plan Category	Number of Shares to be Issued Upon Exercise	Weighted Average Exercise Price	Number of Securities Available for Issuance
Plans Approved by Stockholders	1,441,405	\$1.24	496,595
Plans Not Approved by Stockholders	262,000	1.42	---
Total	1,703,405	\$1.27	496,595

No repurchases were made by the Company of its securities during the fourth quarter ended June 30, 2004.

**Item 6. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion and analysis provides information that the Company's 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, 2003 and 2004, 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. The Company's actual future results could differ materially from those discussed herein. The Company's critical accounting policies relate to inventory valuation for slow moving items, impairment of goodwill, and recoverability of deferred income taxes.

**Critical Accounting Estimates and Judgments**

The Company's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States (GAAP). The preparation of the Company's financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosures. The Company bases its 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 under different assumptions or conditions. The significant accounting policies that are believed to be the most critical to aid in fully understanding and evaluating the reported financial results include inventory valuations for slow moving items, impairment of goodwill, and the recovery of deferred income tax assets.

The Company determines its inventory value at the lower of cost (first-in, first-out method) or market value and calculates 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 its prior twelve month sales. If over twenty four months of inventory for a specific part is believed to be on hand, 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 sales history, and expected near term sales prospects.

On July 1, 2002 the Company 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. The Company has compared the carrying value of the Santa Ana location with the estimated fair value of the business operations at that location and determined that none of the goodwill recorded as of June 30, 2002 or as of April 1, 2004 was impaired.

In accordance with the requirements of SFAS No. 142, the Company has recorded no impairment charge in 2003 or 2004. The Company prepares its annual impairment testing on April 1 of each year. The Company has compared the estimated carrying value of the Santa Ana location with the estimated fair value of the operations there and determined that none of the goodwill recorded as of April 1, 2004 was impaired. There is no associated goodwill remaining with the Beaverton location.

As part of the process of preparing the Company's consolidated financial statements, the Company is required to estimate its income taxes in each of the jurisdictions in which it operates. This process involves the Company 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. The Company must then assess the likelihood that the deferred tax assets will be recovered from future taxable income and to the extent the Company believes that recovery is not likely, a valuation allowance must be established. To the extent the Company establishes a valuation allowance or increases this allowance in a period, the impact will be included in the tax provision in the statement of operations.

Significant management judgment is required in determining the Company's provision for income taxes and the recoverability of the deferred tax asset. It is based on estimates of future taxable income by jurisdiction in which the Company operates and the period over which the deferred tax assets will be recoverable. In the event that actual results differ from these estimates or the Company adjusts 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.

### Selected Financial Data

The following table sets forth selected financial data regarding the Company's financial position and operating results. This data should be read in conjunction with the Company's Consolidated Financial Statements and the Notes thereto and "Management's Discussion and Analysis of Financial Condition and Results of Operations."

(in thousands)

	Year Ended June	
	30,	
	2004	2003
<u>Statement of Operations Data</u>		
Net sales	\$ 14,200	\$ 11,990
Cost of sales	<u>7,395</u>	<u>7,075</u>
Gross profit	6,805	4,915
Operating expenses	<u>4,972</u>	<u>4,609</u>
Income from operations	1,833	306
Net other expense (income)	(69)	51
Income tax provision	<u>782</u>	<u>122</u>
Net income	\$ <u>1,120</u>	\$ <u>133</u>

**Results of Operations****Results of Operations for Fiscal Year Ended June 30, 2004, Compared to Fiscal Year Ended June 30, 2003**

The following table sets forth for the periods indicated the percentage of net revenues represented by each item in the Company's Consolidated Statements of Income.

	Year Ended June 30,	
	2004	2003
Net Sales:	100.0%	100.0%
Cost of Sales	52.0	59.0
Gross profit	48.0	41.0
Selling, general and administrative expenses	22.5	26.0
research and development costs	12.6	12.2
amortization	--	0.2
Income from operations	12.9	2.6
Net other income (loss)	0.5	(0.5)
Income before income tax provision	13.4	2.1
Income tax provision	(5.5)	(1.0)
Net income	7.9%	1.1%

**Net Sales.** Consolidated sales increased 18% for the year ended June 30, 2004, compared to the year ended June 30, 2003, due to increased sales at both Company locations. The shift in sales mix to emphasize medical sales continued as medical sales increased 68% as compared to 2003. Semiconductor and industrial sales also increased significantly as the industry rebounded from its cyclical downturn. Although selective price increases and decreases were implemented in response to market conditions, the majority of the sales growth and declines for each product line is due primarily to increased or decreased sales volume, not the effect of these price changes.

Net sales by customer type were as follows:

	Year ended June 30,		Increase/ (Decrease)
	2004	2003	
Dental	\$ 4,578,000	\$ 5,213,000	(12%)
Medical	5,864,000	3,481,000	68%
Semi-Conductor and industrial	2,533,000	2,131,000	19%
Government research and other	<u>1,225,000</u>	<u>1,165,000</u>	<u>5%</u>
Total	\$ 14,200,000	\$ 11,990,000	18%

Net sales by segment and type of customer were as follows:

	Year ended June 30,		Increase/ (Decrease)
	2004	2003	
Dental	\$ 4,578,000	\$5,213,000	(12%)
Medical	5,123,000	2,851,000	80%
Semi-Conductor and industrial	654,000	730,000	(10%)
Government research and other	<u>545,000</u>	<u>487,000</u>	<u>12%</u>
Rotary Drives	\$10,900,000	9,281,000	17%
Medical	741,000	630,000	18%
Semi-Conductor and industrial	1,879,000	1,401,000	34%
Government research and other	<u>680,000</u>	<u>678,000</u>	<u>0%</u>
Motion Control	<u>3,300,000</u>	<u>2,709,000</u>	<u>22%</u>
Total	<u>\$14,200,000</u>	<u>\$11,990,000</u>	18%

**Gross profit and margin.** The Company's consolidated gross profit for 2004 increased \$1,890,000 or 38% over the gross profit in the previous year due to increased sales and higher margins from both the rotary motion and motion control segments. Gross profit as a percentage of sales increased to 48% for the year ended June 30, 2004 compared to 41% for the year ended June 30, 2003. This increase in gross profit is primarily the result of the increased sales of higher margin products to the medical industries and ongoing manufacturing cost reduction efforts.

Gross profits by segment were as follows:

	Year ended June 30,		Increase/ (Decrease)
	2004	2003	
Rotary Drives	4,364,000	2,808,000	55%
<u>Motion Control</u>	2,441,000	2,107,000	16%
Total	\$ 6,805,000	\$ 4,915,000	38%

**Selling, general and administrative costs (S, G&A).** S, G & A expenses increased 1% to \$3,182,000 for the year ended June 30, 2004 from \$3,152,000 for year ended June 30, 2003. The increase is mainly due to a \$146,000 increase in sales and marketing expenses that were partially offset by administrative cost saving measures of \$98,000 that were implemented throughout the Company.

S, G & A expenses by segment were as follows:

	Year ended June 30,		Increase/ (Decrease)
	2004	2003	

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Rotary Drives	1,729,000	1,626,000	6%
Motion Control	712,000	700,000	2%
<u>Corporate</u>	741,000	826,000	(10%)
Total	\$ 3,182,000	\$ 3,152,000	1%

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**Research and development costs.** Research and development expenses increased \$333,000 to \$1,790,000 for the year ended June 30, 2004 from \$1,457,000 for the year ended June 30, 2003, an increase of 23%. The increase is due to a higher level of product development work to upgrade the capabilities of the motion control product line and to investigate new applications for the rotary drive system capabilities.

Company funded research and development costs by segment were as follows:

	2004	2003	Increase
Rotary Drives	1,069,000	782,000	36%
<u>Motion Control</u>	721,000	675,000	7%
Total	\$ 1,790,000	\$ 1,457,000	23%

The Company engages in two types of research and development efforts. The first is funded by the Company itself, intended to develop generic rotary drive and multi axis motion control technologies and products that will subsequently be modified to meet the needs of individual customers. The results of the development work are intended to provide the Company with long-term exclusive manufacturing agreements and provide the customer with retention of the intellectual property developed. In this initial phase, there are generally no revenues generated and the associated costs are expensed as incurred.

The second type of research and development effort is the work performed for and funded by specific customers under the terms of a formal research and development agreement. These efforts are generally for specific modifications to the generic products developed by the Company-funded research. These projects typically take place within twelve months of the generic development work being completed. The Company recognizes revenue under these research and development agreements as certain deliverables are met as specified in each development contract. The research and development costs associated with these efforts are capitalized as inventory and recognized as costs of sales (COS) when the contracted deliverable is made, matching the cost to the revenue and reducing the performance and collection risk to the Company. Customer funded research and development provided \$426,000 and \$892,000 in revenue in the years ended June 30, 2004 and June 30, 2003, respectively. In the year ended June 30, 2004, \$221,000 was recognized as COS, and was \$442,000 recognized as cost of goods sold in the year ended June 30, 2003.

The following table segments the Company's research and development efforts for the year ended June 30, 2004 and June 30, 2003 into two segments and three categories of the type of work performed.

	Motion Control Year ended June 30,		Rotary Drive Year ended June 30,	
	2004	2003	2004	2003
Technology research and development	\$ 216,000	\$ 371,000	\$ 130,000	\$ 122,000
Design development	433,000	236,000	710,000	857,000
Process development	<u>72,000</u>	<u>68,000</u>	<u>450,000</u>	<u>245,000</u>
Total research and development	721,000	675,000	1,290,000	1,224,000
Less: amounts recognized as COS	<u>-----</u>	<u>-----</u>	<u>(221,000)</u>	<u>(442,000)</u>
Net research and development expense	\$ <u>721,000</u>	\$ <u>675,000</u>	\$ <u>1,069,000</u>	\$ <u>782,000</u>

The disclosure of customer names, project status and economic impact of projects that are fundamental to the Company's business strategy is prohibited in many cases by confidentiality agreements.

**Income from operations and margin.** The Company's consolidated income from operations for the year ended June 30, 2004 increased 500% to \$1,834,000 compared to \$306,000 for 2003. This increase is due to an increase in sales level, a more profitable sales mix and better control of expenses throughout the Company. Income from operations as a percentage of sales increased to 12.9% in 2004 compared to 2.6% for 2003. Operating Profit increases are due to the richer product mix favoring medical products and a significant increase in the sales of high margin motion control products.

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Operating Profit by segment was as follows:

	2004	2003	Increase
Rotary Drives	1,566,000	400,000	292%
Motion Control	1,008,000	732,000	38%
<u>Corporate</u>	(741,000)	(826,000)	10%
Total	\$ 1,833,000	\$ 306,000	499%

**Royalties and Other Income.** The Company received \$98,000 in royalty payments in 2004, compared to none in the prior year as the shipments under which royalty payments were based began in 2004.

**Net Interest Expense.** Net interest expense was \$51,000 in the year ended June 30, 2004 compared to \$87,000 for the year ended June 30, 2003. The decrease in net interest expense resulted primarily from decreases in interest rates on Company debt and decreases in outstanding balances of the Company's debt.

**Income tax provision.** The Company's effective income tax rate is 41% for the year ended June 30, 2004, compared to 48% for the year ended June 30, 2003. The Company's effective income tax rate in 2004 was reduced compared to 2003 as the taxes related to the 2001 subsidiary divestiture proceeds were recorded in 2003 with no further effect in 2004.

In the year ended June 30, 2003, management recorded a deferred tax valuation allowance of \$227,000. There was no change in the allowance as of June 30, 2004. The valuation allowance has been provided for state tax credits, as management believes that the amount of future state taxable income necessary to utilize these credits is not more likely than not to be realized. Net realizable deferred tax assets could be reduced if estimates of future profitability are reduced or if future changes in the ownership of the Company occur.

As part of the process of preparing its consolidated financial statements, the Company is required to estimate its income taxes in each of the jurisdictions in which we operate. This process involves the Company estimating its 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 Company's 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. The Company must then assess the likelihood that its deferred tax assets will be recovered from future taxable income and to the extent management believes that recovery is not likely, the Company must establish a valuation allowance. To the extent a valuation allowance or increase this allowance is established in a period, the impact will be included in the tax provision in the statement of operations.

**Net Income.** The Company had net income of \$1,120,000 or \$0.13 per share, basic and \$0.12 per share diluted for the year ended June 30, 2004 compared to net income of 133,000 or \$0.02 per share basic and \$0.01 per share diluted for the year ended June 30, 2003. This increase is due to the richer product mix favoring medical products, a significant increase in the sales of high margin motion control products and the beginning of the royalty payments in 2004.

## Liquidity and Capital Resources

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

	Year ended June 30,	
	2004	2003
Cash and cash equivalents	\$2,070,000	\$795,000
Net cash provided by (used in) operations	\$2,054,000	\$503,000
Working Capital <sup>1</sup>	\$5,795,000	\$4,584,000
Credit Line outstanding balance	\$0	\$432,000
Tangible book value/common share <sup>2</sup>	\$0.85	\$0.72
Number of days of sales outstanding (DSO) in accounts receivable at end of quarter <sup>3</sup>	59	50

<sup>1</sup> Working Capital = Ending Current Assets balance - Ending Current liabilities balance

<sup>2</sup> Tangible book value/common share = (Total shareholders' equity - Goodwill)/(basic outstanding shares)

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

The Company's working capital at June 30, 2004 increased to approximately \$5.8 million compared to approximately \$4.6 million at June 30, 2003 as cash generated from operations was primarily maintained for future investments and general corporate purposes. Cash Flow provided by Operations was \$2,054,000 in the year ended June 30, 2004 compared to \$503,000 for the year ended June 30, 2003. Cash was provided through increasing the Company's profitability levels and maintaining low expenditure levels. Management believes that the Company's working capital needs over the next twelve months can be adequately supported by current operations.

The Company's backlog decreased from \$5.1 million at June 30, 2004 compared to \$5.5 million at June 30, 2003. The decreased backlog is due to the Company transitioning to a royalty payment agreement from a manufacturing agreement for its HealOzone product and the timing of the receipt of long-term blanket purchase orders. The backlog is expected to be fully shipped over the next twelve months.

The former subsidiaries of the Company, Micro Motors and OMS, entered into a credit facility with Wells Fargo Business Credit Inc. (WFBCI) in May 2002 for borrowings up to the lesser of \$3,000,000 or the total of the eligible accounts receivable. The credit facility was to expire May 2005 and required monthly interest payments at the prime rate plus 1.00% to 1.75% based on outstanding borrowings, with a minimum interest charge of \$12,500 per quarter. The outstanding borrowings were secured by all assets of the Company's two subsidiaries, Micro Motors and OMS, and were guaranteed by the Company.

In October 2003, the credit facility with WFBCI was ended and refinanced with a more favorable facility by Wells Fargo Bank, N.A. (Wells Fargo) for borrowings up to the lesser of \$2,000,000 or the total of the eligible accounts receivable. The credit facility expires in October 2004 and requires monthly interest payments at the prime rate (4.00% at June 30, 2004) or LIBOR (1.375% (1 month) to 1.625% (three month) at June 30, 2004) plus 2.75% based on outstanding borrowings, with a no minimum interest charge. The outstanding borrowings are secured by all assets of the Company, and are guaranteed by the Company. There was no outstanding balance under the terms of this credit facility as of June 30, 2004. The total additional eligible borrowing capacity based on the receivables balances at June 30, 2004 was \$1,690,000.

The subsidiary merger will have no impact on the credit facility as the assets of the subsidiaries merged into the Company, which was the credit facility guarantor.

There are certain financial and non-financial covenants that the Company must meet to be in compliance with the terms of the credit facility. At June 30, 2004 the Company was in compliance with all covenants.

In September 2002, the Company's Board of Directors authorized the repurchase on the open market of up to 500,000 shares of the Company's outstanding Common Stock, subject to compliance with applicable laws and regulations. There is no requirement that the Company repurchase all or any portion of such shares. The maximum total value of the repurchase is not to exceed \$500,000. This repurchase is to be financed with cash generated by operations. From the inception of the repurchase authorization through the year end date of June 30, 2003, the Company repurchased 75,700 shares of Common Stock for \$43,741, at an average price of \$0.58 per share. No additional shares were repurchased in 2004. The stock repurchase plan is currently inactive as the market value per common share has remained above \$1.25.

At June 30, 2004, the Company had cash and cash equivalents of \$2,070,000. The Company believes that its cash and cash equivalents on hand at June 30, 2004, together with cash flows from operations, if any, and amounts available under the credit facility, will be sufficient to meet its working capital and capital expenditure requirements for fiscal 2005.

### **Impact of Inflation and Changing Prices**

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

### **Item 7. Financial Statements**

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

<u>Report of Independent Registered Public Company Accounting Firm</u>	23
<u>Report of Independent Registered Public Company Accounting Firm</u>	24
<u>Consolidated Balance Sheet</u>	25
<u>Consolidated Statements of Operations</u>	26
<u>Consolidated Statements of Shareholders' Equity</u>	27
<u>Consolidated Statements of Cash Flows</u>	28
<u>Notes to Consolidated Financial Statements</u>	29

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

On October 16, 2003, the Company dismissed McGladrey & Pullen, LLP ("McGladrey") as its independent accountant. The reports of McGladrey on the Company's financial statements for the past two fiscal years contained no adverse opinion or disclaimer of opinion and were not qualified or modified as to uncertainty, audit scope or accounting principles. The Company's decision to change accountants was approved by its Audit Committee. In connection with its audits for the two fiscal years preceding and through October 16, 2003, there had been no disagreements with McGladrey on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreements if not resolved to the satisfaction of McGladrey would have caused them to make reference thereto in their report on the financial statements for such years. During the two most recent fiscal years and through October 16, 2003, there have been no reportable events (as defined in Regulation S-B Item 304(a)(1)(iv)). McGladrey furnished the Company with a letter addressed to the SEC stating that it agrees with the above statements. The Company's Audit Committee approved the engagement of Moss Adams, LLP ("Moss

Adams") as its new independent accountant, for the fiscal year ending June 30, 2004 to replace McGladrey. During the two fiscal years preceding and through October 16, 2003, the Company has not consulted with Moss Adams regarding either (i) the application of accounting principles to a specified transaction, either completed or proposed; or the type of audit opinion that might be rendered on the Company's financial statements; or (ii) any matter that was either the subject of a disagreement, as that term is defined in Item 304(a)(1)(iv) of Regulation S-B and the related instructions to Item 304 of Regulation S-B, or a reportable event, under Item 304(a)(1)(iv) of Regulation S-B. The Company has authorized McGladrey to respond fully to any inquiries from Moss Adams relating to its engagement as Company's independent accountant.

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**Item 8A. Controls and Procedures.**

The Chief Executive Officer and Chief Financial Officer (the principal executive officer and principal financial officer, respectively) have concluded, based on their evaluation as of June 30, 2004 ("Evaluation Date"), that the design and operation of the Company's "disclosure controls and procedures" (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended ("Exchange Act")) are effective to ensure that information required to be disclosed by the Company in the reports filed or submitted by the Company under the Exchange Act is accumulated, recorded, processed, summarized and reported to its management, including its principal executive officer and its principal financial officer, as appropriate to allow timely decisions regarding whether or not disclosure is required.

During the quarter ended June 30, 2004, there were no changes in the Company's internal controls over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act) that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

**Item 8B. Other Information.**

None.

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### **PART III**

#### **Item 9. Directors and Executive Officers of the Registrant**

Information concerning the Company's Directors and Executive Officers is incorporated by reference from the information contained in the Company's definitive Proxy Statement for the Company's 2004 Annual Meeting of Shareholders to be filed with the SEC within 120 days after the end of the fiscal year ended June 30, 2004 (the "Proxy Statement").

#### **Item 10. Executive Compensation**

Information required by this Item is incorporated by reference from the section entitled "Compensation of Executive Officers and Management" contained in the Proxy Statement.

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

Information required by this Item is incorporated by reference from the section entitled "Security Ownership of Certain Beneficial Owners and Management" contained in the Proxy Statement.

#### **Item 12. Certain Relationships and Related Transactions**

Information required by this Item is incorporated by reference from the information contained in the section entitled "Certain Relationships and Related Transactions" contained in the Proxy Statement.

#### **Item 13. Exhibits and Reports on Form 8-K**

- (a) Exhibits (1)
- (b) Reports on Form 8-K:

Form 8-K Filed May 4, 2004 concerning the announcement of financial performance for the quarter ended March 31, 2004.

- (1) See Exhibit Index

#### **Item 14. Principal Accountant Fees and Services**

Information required by this Item is incorporated by reference from the information contained in the section entitled "Principal Accountant Fees and Services" contained in the Proxy Statement.

**Report of Independent Registered Public Accounting Firm**

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

We have audited the accompanying consolidated balance sheets of Pro Dex, Inc. and Subsidiaries (the Company) as of June 30, 2004 and the related consolidated statements of operations, shareholders' equity and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Pro Dex, Inc. and Subsidiaries as of June 30, 2004, and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

**Moss Adams LLP**

Los Angeles, California

August 23, 2004

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**Report of Independent Registered Public Accounting Firm**

To the Board of Directors  
Pro-Dex, Inc.  
Santa Ana, California

We have audited the accompanying consolidated statements of operations, shareholders' equity and cash flows for the year ended June 30, 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the results of their operations and their cash flows for the year ended June 30, 2003, in conformity with accounting principles generally accepted in the United States of America.

As described in Note 2 to the financial statements, effective July 1, 2002, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets"

McGladrey & Pullen, LLP  
August 8, 2003  
Irvine, CA

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**PRO-DEX, INC. and SUBSIDIARIES**  
**BALANCE SHEET**  
**June 30, 2004**

**ASSETS**

## Current assets:

Cash and cash equivalents	\$	2,070,000
Accounts receivable, net of allowance for doubtful accounts of \$40,000		2,370,000
Inventories, net		2,542,000
Prepaid expenses		76,000
Deferred income taxes		793,000
Total current assets		7,851,000

## Equipment and leasehold improvements, net

1,030,000

## Other assets:

Goodwill		1,110,000
Deferred income taxes		788,000
Other		16,000
Total other assets		1,914,000
Total assets	\$	10,795,000

**LIABILITIES AND SHAREHOLDERS' EQUITY**

## Current liabilities:

Current portion of long term debt to shareholder	\$	70,000
Accounts payable		397,000
Accrued expenses		780,000
Income taxes payable		809,000
Total current liabilities		2,056,000

## Long-term debt to a shareholder, net of current portion

75,000

## Total liabilities

2,131,000

## Commitments and contingencies

## Shareholders' equity:

Series A convertible preferred shares; no par value; liquidation preference of \$3.60 per share; 10,000,000 shares authorized; 78,129 shares issued and outstanding		283,000
Common shares; no par value; 50,000,000 shares authorized; 8,858,600 shares issued and outstanding,		15,075,000
Accumulated deficit		(6,669,000)

## Receivable for stock purchase

(25,000)

## Total shareholders' equity

8,664,000

## Total liabilities and shareholders' equity

\$

10,795,000

*See notes to consolidated financial statements.*

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

	2004		2003
Net sales	\$ 14,200,000		\$ 11,990,000
Cost of sales	7,395,000		7,075,000
Gross profit	6,805,000		4,915,000
Operating expenses:			
Selling	857,000		710,000
General and administrative expenses	2,325,000		2,410,000
Research and development costs	1,790,000		1,457,000
Amortization	-		32,000
Total operating expenses	4,972,000		4,609,000
Income from operations	1,833,000		306,000
Other income (expense):			
Other income, net	22,000		36,000
Royalty income	98,000		-
Interest (expense)	(51,000)		(87,000)
Total	69,000		(51,000)
Income before income taxes provision	1,902,000		255,000
Income taxes provision	782,000		122,000
Net income	\$ 1,120,000		\$ 133,000
Net Income per share:			
Basic	\$ 0.13		\$ 0.02
Diluted	\$ 0.12		\$ 0.01
Weighted average shares outstanding - basic	8,799,477		8,743,575
Weighted average shares outstanding - diluted	9,327,423		9,040,893

*See notes to consolidated financial statements.*

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

	Preferred Shares		Common Shares		Accumulated Deficit	Receivable for Stock Purchase	Total
	Number of Shares	Amount	Number of Shares	Amount			
Balance 2002	78,129	\$ 283,000	8,787,300	\$ 15,033,000	\$ (7,922,000)	\$ (76,000)	\$7,318,000
Stock Based Compensation	-	-	-	10,000	-	-	10,000
Treasury stock purchased	-	-	(75,700)	(44,000)	-	-	(44,000)
Services Received	-	-	-	-	-	25,000	25,000
Net Income	-	-	-	-	133,000	-	133,000
Balance 2003	78,129	\$ 283,000	8,711,600	\$ 14,999,000	\$ (7,789,000)	\$ (51,000)	\$ 7,442,000
Warrants exercised	-	-	65,000	35,000	-	-	35,000
Options exercised	-	-	82,000	41,000	-	-	41,000
Services received	-	-	-	-	-	26,000	26,000
Net Income	-	-	-	-	1,120,000	-	1,120,000
Balance 2004	78,129	\$ 283,000	8,858,600	\$ 15,075,000	\$ (6,669,000)	\$ (25,000)	\$ 8,664,000

*See notes to consolidated financial statements.*

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

	2004	2003
Cash Flows from Operating Activities:		
Net Income	\$ 1,120,000	\$ 133,000
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	362,000	375,000
Provision for doubtful accounts	10,000	4,000
Reserve for obsolete inventory	(83,000)	(200,000)
Stock based compensation	25,000	35,000
Deferred taxes	22,000	177,000
Changes in:		
(Increase) in accounts receivable	(760,000)	(4,000)
Decrease in inventories	376,000	289,000
Decrease in prepaid expenses	38,000	3,000
Decrease in other assets	5,000	17,000
Increase (Decrease) in accounts payable and accrued expenses	159,000	(584,000)
Decrease in income taxes receivable	-	330,000
Increase (Decrease) in income taxes payable	780,000	(72,000)
Net Cash provided by Operating Activities	2,054,000	503,000
Cash Flows From Investing Activities:		
Proceeds from sale of discontinued operations	-	790,000
Proceeds from sale of equipment	-	6,000
Purchases of equipment and leasehold improvements	(352,000)	(364,000)
Net Cash provided by (used in) Investing Activities	(352,000)	432,000
Cash Flows from Financing Activities:		
Principal payments on long-term shareholder borrowings	(71,000)	(126,000)
Net (payments) on line of credit	(432,000)	(206,000)
Additional paid in capital	76,000	-
Common stock repurchases	-	(44,000)
Net Cash (used in) Financing Activities	(427,000)	(376,000)
Net Increase in Cash and Cash Equivalents	1,275,000	559,000
Cash and Cash Equivalents, beginning of period	795,000	236,000
Cash and Cash Equivalents, end of period	\$ 2,070,000	\$ 795,000
	<i>Supplemental Information</i>	
Cash payments for interest	\$ 51,000	\$ 110,000
Cash payments (refunds) for income taxes	\$ (15,000)	\$ (313,000)

*See notes to consolidated financial statements.*

**PRO-DEX, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**June 30, 2004 and 2003**

**NOTE 1 - DESCRIPTION OF BUSINESS**

Pro-Dex, Inc. ("Pro-Dex" or the "Company") is a Colorado corporation, organized in 1978, currently conducting business at two locations. The Santa Ana, California location designs, develops and manufactures electric, air, and battery powered rotary drive systems for the medical device industry, electric and air devices for the dental industry, and miniature pneumatic motors for industrial applications. The Beaverton, Oregon location designs and manufactures embedded multi-axis motion controllers used to regulate the motion of servo and stepper motors, predominantly for the semiconductor and medical analysis equipment industries.

**NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Principles of Consolidation**

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant inter-company accounts and transactions, if any, have been eliminated. There was one subsidiary of the Company as of June 30, 2004: Pro-Dex Management Inc. Pro-Dex Management Inc. is a non-operating subsidiary that is the surviving legal entity after the 2001 asset sales. At June 30, 2003, the Company had four subsidiaries: Micro Motors Inc., Oregon Micro Systems Inc. Pro-Dex Management Inc., and PDMI subsidiary B, Inc.

**Basis of Presentation**

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

**Revenue Recognition**

Revenue on product sales is recognized upon shipment to the customer. The Company sells some of its products with a warranty that provides for repairs or replacement of any defective parts for a period after the sale. At the time of the sale, the Company accrues an estimate of the cost of providing the warranty based on prior experience. The Company recognizes revenue under research and development agreements as certain deliverables are met as specified in each development contract.

Management recognizes shipping costs as incurred as a part of the costs sales. The Company incurred shipping charges of approximately \$89,000 and \$112,000 for the years ended June 30, 2004 and 2003, respectively.

**Cash and Cash Equivalents**

The Company considers highly liquid investments with a maturity of three months or less when purchased to be cash equivalents.

**Accounts Receivable**

Trade receivables are carried at original invoice amount less an estimate made for doubtful accounts based on a review of all outstanding amounts on a monthly basis. Management determines the allowance for doubtful accounts by identifying troubled accounts and using historical experience applied to an aging of accounts. Trade receivables are written off when deemed uncollectable. Recoveries of trade receivables previously written off are offset against the allowance when received.

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A trade receivable is considered to be past due if any portion of the receivable balance is outstanding for more than 90 days. Interest is not typically charged on trade receivables. Changes in allowance for doubtful accounts as of June 30, 2004 and 2003 were as follows:

	<u>2004</u>	<u>2003</u>
Balance at the beginning of the year	\$ 30,000	\$ 26,000
Provision charged to income, net of recoveries of \$0 in 2004, and \$19,000 in 2003	<u>10,000</u>	<u>4,000</u>
Balance at the end of the year	<u>\$ 40,000</u>	<u>\$ 30,000</u>

## Stock Options and Warrants

### Accounting for Stock-based Compensation

The Company accounts for stock-based employee compensation under the requirements of Accounting Principles Board (APB) Opinion No. 25, which does not require compensation to be recorded if the consideration to be received is at least equal to fair value at the measurement date. Nonemployee stock-based transactions are accounted for under the requirements of the Financial Accounting Standards Board's Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation*, which requires compensation to be recorded based on the fair value of the securities issued or the services received, whichever is more reliably measurable.

SFAS No. 123 requires the disclosure of pro forma net income and earnings per share had the Company adopted the fair value method. Under SFAS No. 123, the fair value of stock-based awards to employees is calculated through the use of option pricing models, even though such models were developed to estimate the fair value of freely tradable, fully transferable options with vesting restrictions which significantly differ from the Company's stock option awards. These models require subjective assumptions, including future stock price volatility and expected time to exercise, which greatly affect the calculated value. The Company's calculations for the options granted were made using the Black-Scholes option-pricing model. The calculations are based on a single-option valuation approach and forfeitures are recognized as they occur.

The fair value of each grant is estimated at the grant date using the Black-Scholes option-pricing model with the following weighted-average assumptions: no dividend rate for all years; price volatility of 62% to 77% in 2004, of 67% to 73% in 2003; risk-free interest rates of approximately 2.5% to 4.0% in 2004 and 2.8% to 4.1% in 2003; and expected lives of five years.

The following table illustrates the effect on net income and earnings per share had compensation cost for employee stock-based compensation been determined based on the grant date fair values of awards for the year ended June 30, 2004 and 2003, respectively.

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		2004	2003
Net income as reported:		\$ 1,120,000	\$ 133,000
	Add stock-based employee compensation expense included in reported net income, net of related tax effects	---	---
	(Deduct) total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(70,000)	(24,000)
Pro-forma net income:		\$ 1,050,000	\$ 109,000
Basic earnings per share:	As reported	\$ 0.13	\$ 0.02
	Pro forma	\$ 0.12	\$ 0.01
Diluted earnings per share:	As reported	\$ 0.12	\$ 0.01
	Pro forma	\$ 0.11	\$ 0.01

## Inventories

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

Raw materials	\$ 1,068,000
Work in process	242,000
Development costs under contract	23,000
Finished goods	1,517,000
Total	2,850,000
Reserve for slow moving items	(308,000)
Total inventories, net	\$ 2,542,000

Changes in reserve for slow moving inventory as of June 30, 2004 were as follows:

Balance at the beginning of the year	\$ 392,000
Inventory disposed	(84,000)
Balance at the end of the year	\$ 308,000

Changes in allowance for warranty expense as of June 30, 2004 and 2003 were as follows:

	2004	2003
Balance at the beginning of the year	\$ 30,000	\$ 28,000
Provision charged to income	10,000	2,000
Balance at the end of the year	\$ 40,000	\$ 30,000

General warranty expense for the years ended June 30, 2004 and June 30, 2003 was \$50,000 and \$26,000 respectively. The increase was due to higher value of warranty parts reflecting the higher value of parts in the 2004 sales mix.



## Equipment and Leasehold Improvements

Equipment and leasehold improvements are recorded at cost and consist of the following:

Equipment	\$ 3,426,000
Leasehold Improvements	151,000
Total Cost	3,577,000
Accumulated Depreciation	(2,547,000)
Total Equipment and leasehold improvements, net	\$ 1,030,000

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

## Goodwill

On July 1, 2002 the Company 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.

In accordance with the requirements of SFAS No. 142, the Company has recorded no impairment charge in 2003 or 2004. The Company prepares its annual impairment testing on April 1 of each year. The Company has compared the estimated carrying value of the Santa Ana location with the estimated fair value of the operations there and determined that none of the goodwill recorded as of April 1, 2004 was impaired. Additionally, during the quarter ended June 30, 2004, management determined that there are no events or circumstances which have occurred that would indicate an impairment of the goodwill had occurred. There is no associated goodwill remaining with the Beaverton location.

## Stock Repurchase Plan

In September 2002, the Company's Board of Directors authorized the repurchase on the open market of up to 500,000 shares of the Company's outstanding Common Stock, subject to compliance with applicable laws and regulations. There is no requirement that the Company repurchase all or any portion of such shares. The maximum total value of the repurchase is not to exceed \$500,000. The maximum price per share that can be paid is \$1.25. The repurchase is to be financed with cash generated by operations. From the inception of the repurchase authorization through the year-end date of June 30, 2003, the Company repurchased 75,700 shares of Common Stock for \$43,741, at an average price of \$0.58 per share. No additional shares were repurchased in the twelve months ended June 30, 2004. The stock repurchase plan is currently inactive as the market value per common share has remained above \$1.25.

## Income Taxes

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

realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

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## **Use of Estimates**

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

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

Significant management judgment is required to determine the provision for income taxes and the recoverability of deferred tax assets. It is based on estimates of future taxable income by jurisdiction in which the Company operates and the period over which deferred tax assets will be recoverable. In the event that actual results differ from these estimates or adjustments are made to these estimates in future periods, there may need to be an adjustment in the valuation allowance which could result in an additional tax provision up to the net carrying value of the deferred tax assets.

## **Earnings per Share**

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

## **Fair Value of Financial Instruments**

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

## **Research and Development**

The Company engages in two types of research and development efforts. The first is funded by the Company itself, intended to develop generic rotary drive and multi axis motion control technologies and products that will subsequently be modified to meet the needs of individual customers. The results of the development work are intended to provide the Company with long-term exclusive manufacturing agreements and provide the customer with retention of the intellectual property developed. In this initial phase, there are generally no revenues generated and the associated costs are expensed as incurred.

The second type of research and development effort is the work performed for and funded by specific customers under the terms of a formal research and development agreement. These efforts are generally for specific modifications to the generic products developed by the Company-funded research. These projects typically take place within twelve months of the generic development work being completed. The Company recognizes revenue under these research and development agreements as certain deliverables are met as specified in each development contract. The research and development costs associated with these efforts are capitalized as inventory and recognized as costs of sales (COS) when the contracted deliverable is made, matching the cost to the revenue and reducing the performance and collection risk to the Company. Customer funded research and development provided \$426,000 and \$892,000 in revenue in the years ended June 30, 2004 and June 30, 2003, respectively. In the year ended June 30, 2004, \$221,000

was recognized as COS, and was \$442,000 recognized as cost of goods sold in the year ended June 30, 2003.

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The following table segments the Company's research and development efforts for the year ended June 30, 2004 and June 30, 2003 into two segments and three categories of the type of work performed.

	Motion Control Year ended June 30,		Rotary Drive Year ended June 30,	
	2004	2003	2004	2003
Technology research and development	\$ 216,000	\$ 371,000	\$ 130,000	\$ 122,000
Design development	433,000	236,000	710,000	857,000
Process development	<u>72,000</u>	<u>68,000</u>	<u>450,000</u>	<u>245,000</u>
Total research and development	721,000	675,000	1,290,000	1,224,000
Less: amounts recognized as COS	----	----	(221,000)	(442,000)
Net research and development expense	<u>\$ 721,000</u>	<u>\$ 675,000</u>	<u>\$ 1,069,000</u>	<u>\$ 782,000</u>

**NOTE 3 - LINE OF CREDIT**

The Company entered into a credit facility with Wells Fargo Business Credit Inc. (WFBCI) in May 2002 for borrowings up to the lesser of \$3,000,000 or the total of the eligible accounts receivable. The terms of the credit facility were to expire May 2005 and required monthly interest payments at the prime rate plus 1.00% to 1.75% based on outstanding borrowings, with a minimum interest charge of \$12,500 per quarter. The outstanding borrowings were secured by all assets of the Company and were guaranteed by the Company.

In October 2003, the credit facility with WFBCI was ended and refinanced with a more favorable facility by Wells Fargo Bank, N.A. (Wells Fargo) for borrowings up to the lesser of \$2,000,000 or the total of the eligible accounts receivable. The terms of the credit facility expire in October 2004 and require monthly interest payments at the prime rate (4.00% at June 30, 2004) or LIBOR (1.375% (1 month) to 1.625% (three months) at June 30, 2004) plus 2.75% based on outstanding borrowings, with a no minimum interest charge. The outstanding borrowings are secured by all assets of the Company, and are guaranteed by the Company. There was no outstanding balance under the terms of this credit facility as of June 30, 2004. The total additional eligible borrowing capacity based on the receivables balances at June 30, 2004 was \$1,690,000.

There are certain financial and non-financial covenants that the Company must meet to be in compliance with the terms of the credit facility. At June 30, 2004 the Company was in compliance with all covenants.

**NOTE 4 - LONG TERM DEBT TO SHAREHOLDER**

Long-term debt is comprised of a \$400,000 Not to Compete liability offset by a \$243,000 Note Receivable asset. The interest rate on both is 7% annually. The Note Receivable is collateralized by the Not to Compete liability. This debt is subordinated to the line of credit with Wells Fargo. The following tables summarize the remaining net principal values of these instruments classified as debt at June 30, 2004:

Total Not to Compete payable	\$ 400,000
<u>Less: interest portion</u>	<u>30,000</u>
Net Not to Compete payable	<u>\$ 370,000</u>

Total Note Receivable	\$ 243,000
<u>Less: interest portion</u>	<u>18,000</u>
Net Note Receivable	<u>\$ 225,000</u>



Net Not to Compete payable	\$ 370,000
<u>Less: Net Note Receivable</u>	<u>225,000</u>
Total Net Debt to shareholder	<u>\$ 145,000</u>

The following table is a summary of the remaining net principal values of these instruments classified as long-term debt:

Unsecured Net Debt to a shareholder, bearing interest at 7%, net payments of \$19,600 quarterly, including interest to June 30, 2006	\$ 145,000
<u>Less net current portion</u>	<u>70,000</u>
Net Long-term debt	<u>\$ 75,000</u>

#### NOTE 5 - COMMITMENTS AND CONTINGENCIES

The Company leases its existing office and warehouse facilities from unrelated parties. The Santa Ana lease expires in July 2006 and the Beaverton lease expires in October 2007. These leases generally require the Company to pay insurance, taxes, and other expenses related to the leased space. Total rent expense in 2004 and 2003 was \$265,000 and \$264,000, respectively. Future minimum lease payments for the years ending June 30 are:

2005	266,000
2006	267,000
2007	113,000
2008	<u>38,000</u>
Total	<u>\$684,000</u>

The manufacture and distribution of certain products by subsidiaries of the Company involves a risk of legal action, and, from time to time, the Company and its subsidiaries are named as defendants in lawsuits. While the Company's 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 the Company may not ultimately incur liability or that such liability will not be material and adverse.

#### NOTE 6 - Income Taxes

The income taxes provision (credits) for the years ended June 30, 2004 and 2003 is as follows:

	<u>2004</u>	<u>2003</u>
Current taxes provision (credits)	\$ 760,000	\$ (55,000)
Deferred taxes provision	<u>22,000</u>	<u>177,000</u>
Income taxes provision	\$ 782,000	\$ 122,000

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

	Years ended June 30	
	<u>2004</u>	<u>2003</u>
Federal income taxes provision, computed at the statutory rate	\$ 666,000	\$ 87,000

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State income taxes	88,000	13,000
Non-deductible items	4,000	4,000
Other	<u>24,000</u>	<u>18,000</u>
	\$ <u>782,000</u>	\$ <u>122,000</u>

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Deferred income tax assets and liabilities in the accompanying consolidated balance sheet at June 30, 2004 consisted of the following:

Assets:	
Accrued expenses	\$ 127,000
Intangible assets	893,000
Inventories	199,000
Net operating loss carry forward	60,000
Income tax credit carry forward	<u>633,000</u>
Total	1,912,000
Less Valuation Allowance	<u>(227,000)</u>
Total deferred tax assets	<u>1,685,000</u>
Liabilities: Depreciation	<u>(104,000)</u>
Net deferred tax assets	\$ <u>1,581,000</u>

The Company has net operating loss carry forwards of \$2,012,000 for State income tax purposes. State loss carry forwards begin to expire in 2012. Tax credit carry forwards totaling \$325,000 for federal tax purposes expire beginning in 2018. The components giving rise to the net deferred tax assets described above have been included in the accompanying balance sheet as of June 30, 2004 and 2003 as follows:

Non-current assets	\$ 793,000
Current assets	<u>788,000</u>
Net deferred tax assets	<u>\$ 1,581,000</u>

The valuation allowance for deferred tax assets as of June 30, 2004 and 2003 was \$227,000. Net realizable deferred tax assets could be reduced if estimates of future profitability are reduced or if future changes in the ownership of the Company occur.

## NOTE 7 - SHAREHOLDERS' EQUITY

### Stock Options

The Board of Directors and the shareholders of the Company have approved and adopted two stock option plans, pursuant to which options to purchase an aggregate of 2,000,000 shares of common stock that may be granted to officers, directors, and employees of the Company. There are 496,595 shares remaining in the option plans that are available for grant in future years. Transactions involving the Company's stock options for the years ended June 30, 2004 and 2003 are summarized as follows:

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<u>Fixed Options</u>	<u>2004</u>		<u>2003</u>	
	<u>Shares</u>	<u>Weighted-Average Exercise Price</u>	<u>Shares</u>	<u>Weighted-Average Exercise Price</u>
Outstanding at beginning of year	1,363,405	\$1.11	1,619,505	\$1.28
Granted	185,000	1.82	460,000	0.64
Exercised	(82,000)	0.50	--	--
Forfeited	(25,000)	1.16	(716,100)	1.13
Outstanding at end of year	1,441,405	\$1.24	1,363,405	\$1.11
Exercisable at end of year	1,023,955	\$1.28	843,063	\$1.22
Weighted-average fair value per Option granted during the year		<u>\$1.07</u>		<u>\$0.20</u>

A further summary concerning fixed options outstanding June 30, 2004, is as follows:

<u>Range of Exercise Price</u>	<u>Options Outstanding</u>			<u>Options Exercisable</u>	
	<u>Number Outstanding</u>	<u>Weighted- Average Remaining Contractual Life</u>	<u>Weighted Average Exercise Price</u>	<u>Number Exercisable</u>	<u>Weighted- Average Exercise Price</u>
\$0.35 to \$0.66	278,000	8.1 years	\$0.42	218,000	\$0.40
\$0.80 to \$1.12	559,900	7.4 years	0.86	367,450	0.87
\$1.40 to \$2.06	335,000	8.1 years	1.69	170,000	1.64
\$2.12 to \$2.75	268,505	4.4 years	2.32	268,505	2.32
	1,441,405	7.2 years	\$ 1.24	1,023,955	\$1.28

The option plans are substantially similar, call for vesting as approved by the Board of Directors, and allow for the options to be outstanding for a period of up to ten years.

### Stock Warrants

In prior years, the Company issued warrants to acquire shares of common stock. At June 30, 2004, warrants to acquire 262,000 shares of common stock were outstanding. These warrants are fully vested, have a weighted-average exercise price of \$1.42, and a weighted-average remaining life 3.0 years. In August, 2003, warrants representing 65,000 common shares were exercised in full at a price of \$0.54 for a total of \$35,100.

### Preferred Shares

Holder of Series A preferred shares have no voting, dividend, or redemption rights. In the event of liquidation or dissolution, preferred shareholders are entitled to receive \$3.60 per share. Each preferred share is convertible into one common share at the option of the holder. To date, no Series A preferred shares have been converted.

### NOTE 8 -BUSINESS DIVESTITURES AND DISCONTINUED OPERATIONS

On June 12, 2001, the Company sold substantially all of the assets of its wholly owned subsidiaries, Biotrol International, Inc. and Challenge Products, Inc. to Young Colorado, LLC, for a purchase price of \$9,100,000. The assets sold comprised the Company's line of infection control and preventive chemical products for the dental industry. The Company received \$688,000 of the remaining escrow balance of \$790,000 in the quarter ending September 30, 2002, and the final \$122,000 was received in October 2002, resulting in no additional gain or loss, completing the distribution of funds in escrow.

During the year ended June 30, 2002, the Company received indemnification notices from Young, to recover alleged losses and costs as they are incurred for certain alleged breaches of representations and warranties contained in the Young Asset Purchase Agreement related to compliance issues with the Food, Drug, and Cosmetic Act ("FDCA"), Federal Insecticide, Fungicide and Rodenticide Act ("FIFRA"), and other related laws. In February 2002, the Company settled a complaint with the Environmental Protection Agency ("EPA") set forth in Young's indemnification notice for alleged violations of FIFRA. Pursuant to the settlement, the Company agreed to pay \$150,000 to the EPA, over a 15-month period, commencing March 2002. The full \$150,000 settlement had been paid by April 30, 2003, leaving in managements' opinion, no additional liability under either Act.

#### NOTE 9 - SEGMENT INFORMATION

The Company's reportable segments are strategic business units that offer different products and services. They are managed separately as each business requires different technology and marketing strategies.

There are two reportable segments within Pro-Dex: Rotary Drives (formerly Micro Motors) and Motion Control (formerly Oregon Micro Systems). The accounting policies applied to determine the segment information are the same as those described in the summary of significant accounting policies. Interest expense is allocated based upon the specific identification of debt incurred by the individual segment. Corporate overhead, the provision for income taxes, and loss from discontinued operations are included in corporate profit, and are not allocated to the individual reported segments. Intersegment sales and transfers are accounted for at amounts that management believes provides the transferring segment with fair compensation for the products transferred, considering their condition, market demand, and, where appropriate, a reasonable profit that recognizes which segment will be responsible for marketing costs. Management evaluates the performance of each segment based on operating income (loss) before interest, other income and income taxes.

Operating Segment data for 2004 and 2003 is as follows (in thousands):

	Rotary Motion			
2004	Devices	Control	Corporate	Total
Sales to external customers	\$10,900	\$3,300	--	\$14,200
Depreciation and amortization	306	56	--	362
Interest expense	49	2	--	51
Segment operating profit (loss)	1,566	1,008	(741)	1,833
Segment assets	6,781	2,415	1,599	10,795
Goodwill	1,110	--	--	1,110
Expenditure for segment assets	278	74	--	352

	Rotary Motion			
2003	Devices	Control	Corporate	Total
Sales to external customers	\$9,281	\$2,709	--	\$11,990
Depreciation and amortization	298	77	--	375
Interest expense	87	--	--	87
Segment operating profit (loss)	400	732	(826)	306

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Segment assets	5,918	1,376	1,810	9,104
Goodwill	1,110	--	--	1,110
Expenditure for segment assets	298	66	--	364

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**Note 10 - Net INCOME per share**

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

	2004	2003
Net income	\$ 1,120,000	\$ 133,000
Basic net income per common share:		
Weighted average of common shares outstanding	8,799,477	8,743,575
Basic net income per common share	\$ 0.13	\$ 0.02
Diluted net income per share:		
Weighted average of common shares outstanding	8,799,477	8,743,575
Effect of potentially dilutive securities (options)	394,486	194,940
Effect of potentially dilutive securities (warrants)	55,331	24,249
Effect of potentially dilutive securities (convertible Preferred Shares)	78,129	78,129
Weighted average number of common shares outstanding - Diluted	9,327,423	9,040,893
Diluted net income per common share	\$ 0.12	\$ 0.01

**Note 11 - MAJOR CUSTOMERS**

The Company had one Major Customer (defined as a customer that represents greater than 10% of the Company's total revenues) in each of the years ended June 30, 2003 and 2004. The 10% customer was a different customer in 2004 and 2003. Net sales to the Major Customer in 2004 amounted to \$2,480,000 and at June 30, 2004 the accounts receivable included a balance of \$335,000 due from this Major Customer. Net sales to the Major Customer in 2003 amounted to \$1,323,000 and at June 30, 2003 the accounts receivable include a balance of \$14,000 due from that Major Customer.

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**EXHIBIT INDEX**

<b>Exhibit No.</b>	<b>Document</b>
2.2	Merger Agreement between Pro-Dex, Inc., Micro Systems Acquisition Corporation, and Micro Motors, Inc., dated July 26, 1995 (incorporated herein by reference to the Company's Form 8-K dated July 26, 1996)
2.3	Acquisition Agreement between Pro-Dex, Inc., Oregon Micro Systems, Inc. and L. Wayne Hunter dated July 26, 1996 (incorporated herein by reference to Exhibit 7.2 to the Company's Form 8-K dated July 26, 1996).
2.4 <sup>x</sup>	Merger agreement of Micro Motors Inc. into Pro-Dex Inc. dated June 28, 2004
2.5 <sup>x</sup>	Merger agreement of Oregon Micro Systems Inc. into Pro-Dex Inc. dated June 28, 2004
2.6 <sup>x</sup>	Merger agreement of PDMI Subsidiary B Inc. into Pro-Dex Management Inc. dated June 28, 2004
3.1	Articles of Incorporation (incorporated herein by reference to Exhibit 3.1 to Pro-Dex, Inc. Registration Statement No. 33-74397).
3.2	Bylaws (incorporated herein by reference to Exhibit 3.2 to Pro-Dex, Inc. Registration Statement No. 33-74397).
10.16	Prophy Ring Patent License Agreement dated and effective July 1, 1993 between Challenge Products, Inc. and Charles L. Bull (incorporated herein by reference to Exhibit 10.17 to Pro-Dex, Inc. Registration Statement No. 33-74397).
10.17*	1994 Employees Stock Option Plan
10.18*	1994 Directors Stock Option Plan as amended
10.19*	2004 Employees Stock Option Plan Charter (incorporated herein by reference to Company's Form S-8 filed January 23, 2004).
10.20*	2004 Directors Stock Option Plan Charter (incorporated herein by reference to Form S-8 filed January 23, 2004).
10.26	Audit Committee Charter (incorporated herein by reference to Company's Form 10-KSB filed October 1, 2002).
10.27	Real Property Sale by Challenge subsidiary (PDMI subsidiary C) Settlement Statement (incorporated herein by reference to Company's Form 10-KSB filed October 1, 2002).
10.28	Acquisition Agreement between Pro-Dex, Inc., Oregon Micro Systems, Inc. and L. Wayne Hunter dated July 26, 1996 (incorporated herein by reference to Exhibit 7.2 to the Company's Form 8-K dated July 26, 1996).
10.29	Asset Sale Agreement dated June 12, 2001, by and among Young Colorado, LLC, Pro-Dex, Inc., Pro-Dex Management, Inc., Biotrol International, Inc., and Challenge Products, Inc. (incorporated herein by reference to the Form 8-K filed July 30, 2001).
10.30	Micro Motors Credit and Security Agreements with WFBCI (incorporated herein by reference to Company's Form 10-KSB filed October 1, 2002).
10.31	OMS Credit and Security Agreements with WFBCI (incorporated herein by reference to Company's Form 10-KSB filed October 1, 2002).
10.32	Promissory Note receivable from Ronald G. Coss
10.33* <sup>x</sup>	Employment agreement as amended with Patrick Johnson dated April 3, 2000, amended September 6, 2002
21.00 <sup>x</sup>	List of Subsidiaries
21.01	During the fiscal year ended June 30, 2004, the Company's wholly owned subsidiaries, Micro Motors, Inc., a Colorado corporation, and Oregon Micro Systems, Inc., an Oregon corporation, were merged into the Company and PDMI subsidiary B, a Delaware corporation merged into Pro-Dex Management Inc., a California Corporation and wholly owned subsidiary of the Company.
23.1 <sup>x</sup>	Consent Letter of McGladrey & Pullen LLP
23.2 <sup>x</sup>	Consent Letter of Moss Adams LLP

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- 31.1<sup>x</sup> Certification of the Chief Executive Officer Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2<sup>x</sup> Certification of the Chief Financial Officer Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32<sup>x</sup> Certification of the Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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

<sup>x</sup> Filed Herewith

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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.

PRO-DEX INC.

By: / s / Patrick Johnson

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Patrick Johnson  
Chief Executive Officer  
and President

In accordance with the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

/ s / Patrick Johnson                      September 27, 2004  
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Patrick Johnson                      Date  
President and Chief  
Executive Officer  
(Principal Executive Officer)

/ s / Jeffrey J. Ritchey                      September 27, 2004  
-----

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

/ s / George J. Isaac                      September 27, 2004  
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George J. Isaac                      Date  
Director

/ s / Mark P. Murphy                      September 27, 2004  
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Mark P. Murphy                      Date  
Director

/ s / Michael Mesenbrink                      September 27, 2004  
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Michael Mesenbrink                      Date  
Director

/ s / Valerio Giannini                      September 27, 2004  
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Valerio Gianinni                      Date  
Director