

PRO DEX INC
Form 10-Q
February 07, 2012
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended December 31, 2011

OR

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

Commission File Number 0-14942

PRO-DEX, INC.

(Exact name of registrant as specified in its charter)

Edgar Filing: PRO DEX INC - Form 10-Q

Colorado
(State or Other Jurisdiction of

84-1261240
(IRS Employer Identification No.)

Incorporation or Organization)

2361 McGaw Avenue, Irvine, California 92614

(Address of Principal Executive Offices)

Registrant's telephone number: 949-769-3200

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

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

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

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company
Indicate whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

Indicate the number of shares outstanding of each of the Registrant's classes of Common Stock outstanding as of the latest practicable date: 3,272,350 shares of Common Stock, no par value, as of February 6, 2012.

Table of Contents

INDEX

Pro-Dex, Inc.

| | |
|--|----|
| Part I. Financial Information | 1 |
| <u>Item 1. Financial Statements (unaudited):</u> | 1 |
| <u>Condensed consolidated balance sheets – December 31, 2011 and June 30, 2011</u> | 1 |
| <u>Condensed consolidated statements of income – Three months ended December 31, 2011 and 2010</u> | 2 |
| <u>Condensed consolidated statements of income – Six months ended December 31, 2011 and 2010</u> | 3 |
| <u>Condensed consolidated statements of cash flows – Six months ended December 31, 2011 and 2010</u> | 4 |
| <u>Notes to condensed consolidated financial statements – December 31, 2011</u> | 5 |
| <u>Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations</u> | 14 |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u> | 23 |
| <u>Item 4T. Controls and Procedures</u> | 23 |
| <u>Part II. Other Information</u> | 23 |
| <u>Item 1. Legal Proceedings</u> | 23 |
| <u>Item 1A. Risk Factors</u> | 24 |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u> | 24 |
| <u>Item 3. Defaults Upon Senior Securities</u> | 24 |
| <u>Item 4. [Removed and Reserved.]</u> | 24 |
| <u>Item 5. Other Information</u> | 24 |
| <u>Item 6. Exhibits</u> | 24 |
| <u>Signatures</u> | 25 |

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

| | December 31, 2011 | June 30, 2011 |
|--|--------------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 4,267,000 | \$ 4,689,000 |
| Accounts receivable, net of allowance for doubtful accounts of \$13,000 at December 31, 2011 and \$7,000 at June 30, 2011 | 2,248,000 | 3,128,000 |
| Other current receivables | 52,000 | 12,000 |
| Inventories | 4,733,000 | 3,703,000 |
| Prepaid expenses | 234,000 | 145,000 |
| Deferred income taxes | 162,000 | 163,000 |
| Total current assets | 11,696,000 | 11,840,000 |
| Property, plant, equipment and leasehold improvements, net | 3,559,000 | 3,661,000 |
| Other assets | 53,000 | 60,000 |
| Total assets | \$ 15,308,000 | \$ 15,561,000 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 1,624,000 | \$ 1,207,000 |
| Accrued expenses | 1,744,000 | 2,379,000 |
| Income taxes payable | 30,000 | 78,000 |
| Current portion of bank term loan | 357,000 | 357,000 |
| Total current liabilities | 3,755,000 | 4,021,000 |
| Non-current liabilities: | | |
| Bank term loan | 595,000 | 774,000 |
| Deferred income taxes | 162,000 | 163,000 |
| Deferred rent | 285,000 | 279,000 |
| Total non-current liabilities | 1,042,000 | 1,216,000 |
| Total liabilities | 4,797,000 | 5,237,000 |
| Commitments and contingencies | | |
| Shareholders' equity: | | |
| Common shares; no par value; 50,000,000 shares authorized; 3,272,350 shares issued and outstanding at December 31, 2011 and at June 30, 2011 | 16,777,000 | 16,744,000 |
| Accumulated deficit | (6,266,000) | (6,420,000) |
| Total shareholders' equity | 10,511,000 | 10,324,000 |
| Total liabilities and shareholders' equity | \$ 15,308,000 | \$ 15,561,000 |

See notes to condensed consolidated financial statements.

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

| | For The Three Months Ended December 31, | |
|---|--|------------------|
| | 2011 | 2010 |
| Net sales | \$ 4,907,000 | \$ 6,157,000 |
| Cost of sales | 3,504,000 | 3,733,000 |
| Gross profit | 1,403,000 | 2,424,000 |
| Operating expenses: | | |
| Selling expenses | 369,000 | 351,000 |
| General and administrative expenses | 709,000 | 897,000 |
| Research and development costs | 607,000 | 605,000 |
| Total operating expenses | 1,685,000 | 1,853,000 |
| Income (loss) from operations | (282,000) | 571,000 |
| Other income (expense): | | |
| Interest expense, net | (9,000) | (22,000) |
| Total other income (expense) | (9,000) | (22,000) |
| Income (loss) before provision for income taxes | (291,000) | 549,000 |
| Provision for income taxes | 1,000 | 148,000 |
| Net income (loss) | \$ (292,000) | \$ 401,000 |
| Net income (loss) per share: | | |
| Basic | \$ (0.09) | \$ 0.12 |
| Diluted | \$ (0.09) | \$ 0.12 |
| Weighted average shares outstanding basic | 3,272,350 | 3,263,437 |
| Weighted average shares outstanding diluted | 3,272,350 | 3,272,152 |

See notes to condensed consolidated financial statements.

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

| | For the Six Months Ended December 31, | |
|---|--|-------------------|
| | 2011 | 2010 |
| Net sales | \$ 10,937,000 | \$ 11,986,000 |
| Cost of sales | 7,205,000 | 7,378,000 |
| Gross profit | 3,732,000 | 4,608,000 |
| Operating expenses: | | |
| Selling expenses | 743,000 | 775,000 |
| General and administrative expenses | 1,544,000 | 1,660,000 |
| Research and development costs | 1,269,000 | 1,196,000 |
| Total operating expenses | 3,556,000 | 3,631,000 |
| Income from operations | 176,000 | 977,000 |
| Other income (expense): | | |
| Interest expense, net | (20,000) | (80,000) |
| Total other income (expense) | (20,000) | (80,000) |
| Income before provision for income taxes | 156,000 | 897,000 |
| Provision for income taxes | 2,000 | 154,000 |
| Net income | \$ 154,000 | \$ 743,000 |
| Net income per share: | | |
| Basic | \$ 0.05 | \$ 0.23 |
| Diluted | \$ 0.05 | \$ 0.23 |
| Weighted average shares outstanding basic | 3,272,350 | 3,257,643 |
| Weighted average shares outstanding diluted | 3,292,508 | 3,263,654 |

See notes to condensed consolidated financial statements.

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

| | For The Six Months Ended December 31, | |
|--|--|---------------------|
| | 2011 | 2010 |
| Cash flows from operating activities: | | |
| Net income | \$ 154,000 | \$ 743,000 |
| Adjustments to reconcile net income to net cash used in operating activities: | | |
| Depreciation and amortization | 339,000 | 342,000 |
| Allowance for doubtful accounts | 6,000 | (10,000) |
| Share-based compensation | 33,000 | 12,000 |
| Changes in: | | |
| Accounts receivable | 834,000 | 148,000 |
| Inventories | (1,030,000) | (678,000) |
| Prepaid expenses | (88,000) | (30,000) |
| Other assets | 8,000 | 17,000 |
| Accounts payable and accrued expenses | (213,000) | (597,000) |
| Income taxes payable | (49,000) | (5,000) |
| Net cash used in operating activities | (6,000) | (58,000) |
| Cash flows from investing activities: | | |
| Purchases of equipment and leasehold improvements | (237,000) | (16,000) |
| Net cash used in investing activities | (237,000) | (16,000) |
| Cash flows from financing activities: | | |
| Principal payments on term loan | (179,000) | (200,000) |
| Principal payments on mortgage | | (1,528,000) |
| Proceeds from exercise of stock options | | 27,000 |
| Net cash used in financing activities | (179,000) | (1,701,000) |
| Net decrease in cash and cash equivalents | (422,000) | (1,775,000) |
| Cash and cash equivalents, beginning of period | 4,689,000 | 3,794,000 |
| Cash and cash equivalents, end of period | \$ 4,267,000 | \$ 2,019,000 |

Supplemental Information

| | | |
|--------------------------------|-----------|------------|
| Cash payments for interest | \$ 10,000 | \$ 21,000 |
| Cash payments for income taxes | \$ 53,000 | \$ 159,000 |

See notes to condensed consolidated financial statements.

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

The accompanying unaudited condensed consolidated financial statements of Pro-Dex, Inc. (we , us , our , Pro-Dex or the Company) have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Regulation S-K. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. These financial statements should be read in conjunction with the audited financial statements presented in our Annual Report on Form 10-K for the fiscal year ended June 30, 2011. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. The results of operations for such interim periods are not necessarily indicative of the results that may be expected for the full year. For further information, refer to the consolidated financial statements and footnotes thereto included in our Annual Report on Form 10-K for the year ended June 30, 2011.

Recent Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board (FASB) issued amended guidance on fair value measurement and related disclosures. The new guidance clarified the concepts applicable for fair value measurement of non-financial assets and requires the disclosure of quantitative information about the unobservable inputs used in a fair value measurement. This guidance will be effective for reporting periods beginning after December 15, 2011, and will be applied prospectively. We are in the process of evaluating the financial and disclosure impact of this guidance. We do not anticipate a material impact on our consolidated financial statements as a result of the adoption of this amended guidance.

In June 2011, the FASB issued amended guidance on the presentation of comprehensive income. The amended guidance eliminates one of the presentation options provided by current U.S. GAAP, that is to present the components of other comprehensive income as part of the statement of changes in shareholders' equity. In addition, it gives an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. This guidance will be effective for reporting periods beginning after December 15, 2011 and will be applied retrospectively. We are in the process of evaluating the disclosure impact of this guidance.

NOTE 2. INVENTORIES

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

| | December 31, 2011 | June 30, 2011 |
|--|--------------------------|----------------------|
| Raw materials and purchased components | \$ 1,967,000 | \$ 1,659,000 |
| Work in process | 1,178,000 | 746,000 |
| Finished goods and manufactured components | 1,588,000 | 1,298,000 |
| Total inventories | \$ 4,733,000 | \$ 3,703,000 |

At December 31, 2011, the Company included inventory in-transit from vendors at that date with raw materials and purchased components, rather than with finished goods and manufactured components as had been the historical presentation. Amounts at June 30, 2011 have been reclassified to conform to the current period presentation.

Table of Contents**NOTE 3. WARRANTY**

The warranty accrual is based on historical costs of warranty repairs and expected future identifiable warranty expenses, and is included in accrued expenses in the accompanying consolidated balance sheets. As of December 31, 2011 and June 30, 2011 the warranty reserve amounted to \$729,000 and \$732,000, respectively. Warranty expenses are included in cost of sales in the accompanying consolidated statements of income. Changes in estimates to previously established warranty accruals result from current period updates to assumptions regarding repair costs and warranty return rates, and are included in current period warranty expense. Total warranty expense for the three months ended December 31, 2011 and 2010 was \$276,000 and \$78,000, respectively, and for the six months ended December 31, 2011 and 2010 was \$510,000 and \$182,000, respectively.

Information regarding the accrual for warranty costs for the three and six months ended December 31, 2011 and 2010 are as follows:

| | Three months Ended December 31, | |
|---|--|-------------------|
| | 2011 | 2010 |
| Balances, beginning of period | \$ 713,000 | \$ 682,000 |
| Accruals during the period | 143,000 | 133,000 |
| Changes in estimates of prior period accruals | 133,000 | (55,000) |
| Warranty expenditures | (260,000) | (152,000) |
| Balances, end of period | \$ 729,000 | \$ 608,000 |

| | Six months Ended December 31, | |
|---|--|-------------------|
| | 2011 | 2010 |
| Balances, beginning of period | \$ 732,000 | \$ 686,000 |
| Accruals during the period | 290,000 | 295,000 |
| Changes in estimates of prior period accruals | 220,000 | (113,000) |
| Warranty expenditures | (513,000) | (260,000) |
| Balances, end of period | \$ 729,000 | \$ 608,000 |

The changes in estimates recorded during the three and six months ended December 31, 2011 and 2010 were due primarily to fluctuations in per-unit warranty repair costs and the effects of those fluctuations on our estimates of future warranty repair costs.

Table of Contents**NOTE 4. NET INCOME (LOSS) PER SHARE**

The difference in the weighted average shares outstanding used in the calculation of basic and diluted net income (loss) per share for the three and six months ended December 31, 2011 and 2010 is as follows:

| | Three Months Ended December 31, | |
|--|--|-------------|
| | 2011 | 2010 |
| Net income (loss) | \$ (292,000) | \$ 401,000 |
| Basic: | | |
| Weighted average common shares outstanding | 3,272,350 | 3,263,437 |
| Shares used in the computation of basic net income (loss) per share | 3,272,350 | 3,263,437 |
| Net income (loss) per share basic | \$ (0.09) | \$ 0.12 |
| Diluted: | | |
| Shares used in the computation of basic net income (loss) per share | 3,272,350 | 3,263,437 |
| Net shares assumed issued using the treasury stock method for outstanding common stock options | | 8,715 |
| Shares used in the computation of diluted net income (loss) per share | 3,272,350 | 3,272,152 |
| Net income (loss) per share diluted | \$ (0.09) | \$ 0.12 |
| | | |
| | Six Months Ended December 31, | |
| | 2011 | 2010 |
| Net income | \$ 154,000 | \$ 743,000 |
| Basic: | | |
| Weighted average common shares outstanding | 3,272,350 | 3,257,643 |
| Shares used in the computation of basic net income per share | 3,272,350 | 3,257,643 |
| Net income per share basic | \$ 0.05 | \$ 0.23 |
| Diluted net income per share: | | |
| Shares used in the computation of basic net income per share | 3,272,350 | 3,257,643 |
| Net shares assumed issued using the treasury stock method for outstanding common stock options | 20,158 | 6,011 |
| Shares used in the computation of diluted net income per share | 3,292,508 | 3,263,654 |
| Net income per share diluted | \$ 0.05 | \$ 0.23 |

Potentially dilutive securities, consisting of options to purchase shares of our common stock as described in Note 7, are not included in the calculation of diluted loss per share for the three months ended December 31, 2011 due to their anti-dilutive effect on the diluted loss per share calculations for that period.

Options having exercise prices that are greater than the per share market price for our common stock have been excluded from the diluted per share calculations for the six months ended December 31, 2011, and for the three and six months ended December 31, 2010, due to their

Edgar Filing: PRO DEX INC - Form 10-Q

anti-dilutive effect. Shares represented by such options amounted to 243,340 for the six months ended December 31, 2011, and 147,508 for each of the three and six months ended December 31, 2010.

Table of Contents

NOTE 5. BANK DEBT

Union Bank Credit Facility

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

A revolving credit line of up to \$1,500,000 in borrowing availability, under which no amounts have been borrowed;

A non-revolving credit line of up to \$350,000 in borrowing availability for the purchase of equipment, under which no amounts have been borrowed; and

A term loan of \$1,250,000, of which \$952,000 was outstanding as of December 31, 2011.
The maximum amount of borrowing under the revolving credit line is the lesser of:

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

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

(i) \$400,000; or

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

Based on the foregoing, at December 31, 2011 we had the ability to borrow up to \$1,500,000 on the revolving line of credit.

The revolving credit line's terms require monthly interest payments based on borrowed amounts at a floating interest rate, calculated as Union Bank's Reference Rate plus 0.5% (an aggregate interest rate of 3.75% at December 31, 2011). The line's initial term expires on December 15, 2012, after which it is renewable annually at Union Bank's option. Should Union Bank decide not to renew the line, it must give us a 60-day notice of such decision.

The terms of the non-revolving credit line, which is to be used for equipment purchases, require monthly interest payments based on borrowed amounts at a floating interest rate, calculated as Union Bank's Reference Rate plus 0.5% (an aggregate interest rate of 3.75% at December 31, 2011). The line's availability expires on February 4, 2012. Amounts outstanding under the line, if any, at that date will automatically convert into a three-year term loan at a floating interest rate calculated in the same manner as described above with respect to the non-revolving credit line.

The terms of the \$1.25 million term loan, the proceeds of which were used to pay off in full the Wells Fargo term loan described below, require monthly principal payments of \$29,762, plus interest over its 42-month term. The term loan bears interest at a floating rate, calculated as Union Bank's Reference Rate plus 0.5% (an aggregate interest rate of 3.75% at December 31, 2011).

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

Table of Contents

The Union Bank credit facility agreement contains financial covenants that require us to comply with minimum quarterly liquidity and annual profitability thresholds, non-financial covenants that include monthly, quarterly and annual reporting requirements, and certain operational restrictions. At December 31, 2011, we were in compliance with these covenants and requirements.

Wells Fargo Bank Credit Facility

From November 2008 until February 4, 2011, we had a credit facility with Wells Fargo Bank consisting of the following:

A revolving credit line of up to \$1,000,000 in borrowing availability, under which no amounts were outstanding during its term; and

A five-year term loan with an initial balance of \$2,000,000, of which \$1,167,000 was outstanding at December 31, 2010. On February 4, 2011, the term loan was paid off in full, as discussed further above.

Union Bank Mortgage

In March 2006, we entered into a ten-year mortgage with Union Bank for \$1,650,000. The principal balance of the mortgage bore interest at a fixed annual rate of 6.73%. Payments on the mortgage were \$11,379 per month (based on a 25-year amortization), with the balance of \$1,291,666 in principal due on April 1, 2016. The mortgage was collateralized by our Carson City land and building. On September 16, 2010, we paid the remaining \$1,519,000 balance due on the Union Bank mortgage, fully retiring such indebtedness.

NOTE 6. INCOME TAXES

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

Significant management judgment is required in determining our provision for income taxes and the recoverability of our deferred tax assets. Such determination is based primarily on our historical taxable income, with some consideration given to our estimates of future taxable income by jurisdictions in which we operate and the period over which our deferred tax assets will be recoverable. Due to cumulative taxable losses during the past three years, we maintained a \$2,362,000 valuation allowance against our deferred tax assets as of June 30, 2011.

As of December 31, 2011, the valuation allowance against our deferred tax assets is approximately \$2,344,000. The change in valuation allowance is due primarily to the expected realization of deferred tax attributes in the current year.

As of December 31, 2011, we have accrued \$292,000 of unrecognized tax benefits related to federal and state income tax matters. The amount that would reduce the Company's income tax expense if recognized and result in a corresponding decrease in the Company's effective tax rate is \$105,000.

Table of Contents

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

| | |
|--|-------------------|
| Balance at July 1, 2011 | \$ 277,000 |
| Additions based on tax positions related to the current year | 15,000 |
| Balance at December 31, 2011 | \$ 292,000 |

We recognize accrued interest and penalties related to unrecognized tax benefits in income tax expense when applicable. As of December 31, 2011, no interest or penalties applicable to our unrecognized tax benefits have been accrued since we have sufficient tax attributes available to fully offset any potential assessment of additional tax.

Pro-Dex and its subsidiaries are subject to U.S. federal income tax, as well as income tax of multiple state tax jurisdictions. We are currently open to audit under the statute of limitations by the Internal Revenue Service for the years ended June 30, 2008 and later. Our state income tax returns are open to audit under the statute of limitations for the years ended June 30, 2007 and later. We do not anticipate a significant change to the total amount of unrecognized tax benefits within the next 12 months.

NOTE 7. SHARE-BASED COMPENSATION

We have two equity compensation plans, the Second Amended and Restated 2004 Stock Option Plan (the Employees Plan) and the Amended and Restated 2004 Directors Stock Option Plan (the Directors Plan) (collectively, the Plans), pursuant to which (i) options to purchase shares of common stock, or (ii) restricted shares of common stock, may be granted up to an aggregate amount of 1,333,333 common shares, with 1,066,667 and 266,666 shares distributed between the Employees Plan and the Directors Plan, respectively. The Plans are substantially similar, providing for vesting periods, as determined by the Board for the Employees Plan and six months for the Directors Plan, and allow for the options granted under each to be outstanding for a period of up to ten years, subject to forfeit 30 days after the holder ceases to be an employee or 90 days after the holder ceases to be director, as the case may be. At December 31, 2011, options to purchase an aggregate of 391,351 and 71,667 shares under the Employees Plan and the Directors Plan, respectively, are available to grant in future years. Aggregate share-based compensation expense under the Plans for the three months ended December 31, 2011 and 2010 was \$21,000 and \$9,000, respectively, and for the six months ended December 31, 2011 and 2010 was \$33,000 and \$12,000, respectively.

The following weighted-average assumptions were used in the calculation of share-based compensation expense for options granted during the three and six months ended December 31, 2011 and 2010:

| | Three Months Ended December 31, | |
|-------------------------|--|-------------|
| | 2011 | 2010 |
| Dividend rate | None | None |
| Price volatility | 88% | 44% |
| Risk-free interest rate | 1.0% - 1.2% | 1.8% - 2.1% |
| Expected life | 5.50 years | 5.25 years |

| | Six Months Ended December 31, | |
|-------------------------|--------------------------------------|-------------|
| | 2011 | 2010 |
| Dividend rate | None | None |
| Price volatility | 62% | 43% |
| Risk-free interest rate | 1.0% - 1.3% | 1.8% - 2.1% |
| Expected life | 6.0 years | 6.0 years |

Table of Contents

As of December 31, 2011, there was an aggregate of \$195,000 of unrecognized compensation cost under the Plans related to 267,083 non-vested outstanding stock options with a per share weighted average value of \$1.57. The unrecognized expense is anticipated to be recognized on a straight-line basis over a weighted average period of 1.9 years. Following is a summary of stock option activity for the six months ended December 31, 2011 and 2010:

| | 2011 | | 2010 | |
|--|----------|---------------------------------|----------|---------------------------------|
| | Shares | Weighted-Average Exercise Price | Shares | Weighted-Average Exercise Price |
| Outstanding at beginning of period | 320,842 | \$ 2.71 | 193,843 | \$ 3.94 |
| Granted | 205,000 | 2.04 | 115,000 | 2.01 |
| Exercised | | | (20,500) | 1.27 |
| Forfeited | (14,168) | 2.43 | (27,501) | 4.29 |
| Outstanding at end of period | 511,674 | \$ 2.65 | 260,842 | \$ 3.25 |
| Exercisable at end of period | 244,591 | \$ 3.32 | 156,000 | \$ 3.97 |
| Weighted-average fair value per option granted during the period | | \$ 1.16 | | \$ 0.89 |

Following is a summary of information regarding options outstanding and options exercisable at December 31, 2011:

| Range of Exercise Price | Options Outstanding | | | Options Exercisable | | | | |
|-------------------------|---------------------|--------------------------|------------------------|---------------------------|--------------------|------------------------------------|------------------------|---------------------------|
| | Number Outstanding | Average Contractual Life | Average Exercise Price | Aggregate Intrinsic Value | Number Outstanding | Average Remaining Contractual Life | Average Exercise Price | Aggregate Intrinsic Value |
| \$1.35 to \$2.09 | 308,000 | 9.0 years | \$ 1.86 | \$ 184,851 | 139,000 | 8.5 years | \$ 1.86 | \$ 69,034 |
| \$2.34 to \$4.68 | 160,000 | 8.4 years | 2.95 | 11,800 | 63,000 | 8.5 years | 3.89 | 1,189 |
| \$5.22 to \$5.76 | 20,000 | 3.0 years | 5.51 | | 20,000 | 3.0 years | 5.51 | |
| \$7.65 to \$9.90 | 23,000 | 3.6 years | 8.65 | | 23,000 | 3.6 years | 8.65 | |
| Total | 511,000 | 8.3 years | \$ 2.65 | \$ 196,651 | 245,000 | 7.0 years | \$ 3.32 | \$ 70,223 |

Table of Contents**NOTE 8. MAJOR CUSTOMERS**

Information with respect to two customers, both accounting for sales in excess of 10% of our total sales in each of the three and six-month periods ended December 31, 2011 and 2010 is as follows:

| | As of and for the three months ended December 31, 2011 | | | | As of and for the three months ended December 31, 2010 | | | |
|------------|--|------------------|---------------------|------------------|--|------------------|---------------------|------------------|
| | Sales | Percent of Total | Accounts Receivable | Percent of Total | Sales | Percent of Total | Accounts Receivable | Percent of Total |
| Customer 1 | \$ 880,000 | 7% | \$ 240,000 | 9% | \$ 505,000 | 4% | \$ 159,000 | 6% |
| Customer 2 | \$ 1,906,000 | 16% | \$ 778,000 | 30% | \$ 2,689,000 | 22% | \$ 1,045,000 | 41% |

| | As of and for the six months ended December 31, 2011 | | | | As of and for the six months ended December 31, 2010 | | | |
|------------|--|------------------|---------------------|------------------|--|------------------|---------------------|------------------|
| | Sales | Percent of Total | Accounts Receivable | Percent of Total | Sales | Percent of Total | Accounts Receivable | Percent of Total |
| Customer 1 | \$ 2,541,000 | 21% | \$ 240,000 | 9% | \$ 1,255,000 | 10% | \$ 159,000 | 6% |
| Customer 2 | \$ 4,294,000 | 36% | \$ 778,000 | 30% | \$ 5,472,000 | 46% | \$ 1,045,000 | 41% |

In December 2009, our largest customer informed us that it was in the process of developing, and planned to eventually manufacture, its own surgical devices which are functionally comparable to the products we currently provide to the customer. We have been the exclusive manufacturer of these products since they were developed.

We currently provide this Customer with two products (Product A and Product B) and repair services for such products. Sales for each of these categories for the three and six months ended December 31, 2011 and 2010 were as follows:

| | Three months ended December 31, 2011 | Six months ended December 31, 2011 | Average % of total | Three months ended December 31, 2010 | Six months ended December 31, 2010 | Average % of total |
|------------------------|--------------------------------------|------------------------------------|--------------------|--------------------------------------|------------------------------------|--------------------|
| Product A | \$ 157,000 | \$ 950,000 | 18% | \$ 806,000 | \$ 2,447,000 | 40% |
| Product B | 1,340,000 | 2,531,000 | 62% | 1,489,000 | 2,383,000 | 47% |
| Repairs and components | 409,000 | 813,000 | 20% | 394,000 | 642,000 | 13% |
| Total | \$ 1,906,000 | \$ 4,294,000 | 100% | \$ 2,689,000 | \$ 5,472,000 | 100% |

As of January 2, 2012, the Customer had orders of (i) \$784,000 for Product A scheduled for delivery through April 2012 (ii) \$745,000 for Product B scheduled for delivery through February 2012, and (iii) \$400,000 of components scheduled for delivery through April 2012, all of which the Customer has indicated it plans to purchase. However, the Customer has indicated that it does not plan to place further orders with us for these products.

The Customer has indicated that its plan is contingent on several factors, including the registration of the Customer's product in a foreign jurisdiction and the successful completion of its field testing for the product that will replace Product B.

In addition, the Customer indicated that it plans to limit repair requests from us to those Products A and B that are covered by our product warranty, likely reducing, possibly to zero, future repair revenue for out-of-warranty products.

Table of Contents

Resulting from the foregoing, revenue attributable to the Customer could decline to zero or a negligible amount by the end of fiscal year 2012.

However, the Customer is not obligated either to abide by the timetables it has communicated to us or to update us as to the status of its current plan. Accordingly, we are unable to know or predict the status of the Customer's plan or initiatives on an ongoing basis. The Customer could accelerate, delay or terminate its transition to its own products at any time and without notice to us, which could have a material impact on our revenues. The identity of the Customer is protected by a confidentiality agreement.

We are continuing to implement steps to identify and capture additional revenue opportunities. There can be no assurance, however, as to either the timing or success of achieving this objective, and it would be our intent to reduce operating costs, if and as necessary, to minimize the impact of a revenue reduction, should it occur. In the event that the Customer's future purchases are reduced beyond the realization of such opportunities or cost reductions, we are likely to experience a material and adverse impact on our business.

NOTE 9. COMMITMENTS AND CONTINGENCIES

In February 2011, we became aware of a report entitled "Site Discovery Report, Southeast Santa Ana Project DTSC - Cypress Region," dated February 2010 (the "Report"), that was prepared by the Cypress regional office of the Cal/EPA Department of Toxic Substances Control (DTSC) for Region 9 of the U.S. Environmental Protection Agency (USEPA) under an agreement between the two agencies. The purpose of the Report was to identify sites within an area of southeast Santa Ana, California that may be sources of groundwater contamination previously detected in that area. The Report identified 25 sites, including our former Santa Ana site, for further screening by DTSC staff over the next two years. DTSC has informed us that no further evaluation of our former site took place during fiscal year 2011, and that it has decided not to evaluate our former site during fiscal year 2012. It is uncertain whether future developments, if any, from DTSC's screening process would have any application to our former site.

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

NOTE 10. FAIR VALUE MEASUREMENTS

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

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

Land and building: Land and building are classified within Level 2 of the valuation hierarchy.

Table of Contents

Although the methods above may produce a fair value calculation that may not be indicative of the net realizable value or reflective of future fair values, the Company believes its valuation methods are appropriate

NOTE 11. SUBSEQUENT EVENTS

We have evaluated events or transactions that occurred after the balance sheet date of December 31, 2011 and have identified no such events or transactions which require adjustment to, or disclosure in, these financial statements.

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

The following discussion and analysis provides information that management believes is relevant to an assessment and understanding of the results of operations and financial condition of Pro-Dex, Inc. (Company , Pro-Dex , we , our or us) for each of the three and six-month periods ended December 31, 2011 and 2010. This discussion should be read in conjunction with the Condensed Consolidated Financial Statements and the Notes thereto included elsewhere in this report. This report contains certain forward-looking statements and information. The cautionary statements included herein should be read as being applicable to all related forward-looking statements wherever they may appear. Our actual future results could differ materially from those discussed herein.

Except for the historical information contained herein, the matters discussed in this report, including, but not limited to, discussions of our product development plans, business strategies and market factors influencing our results, are forward-looking statements that involve certain risks and uncertainties. Actual results may differ from those anticipated by us as a result of various factors, both foreseen and unforeseen, including, but not limited to, our ability to continue to develop new products and increase sales in markets characterized by rapid technological evolution, consolidation within our target marketplace and among our competitors, and competition from larger, better capitalized competitors. Many other economic, competitive, governmental and technological factors could impact our ability to achieve our goals. You are urged to review the risks, uncertainties and other cautionary language described in this report, as well as in our other public disclosures and reports filed with the Securities and Exchange Commission (SEC) from time to time, including, but not limited to, the risks, uncertainties and other cautionary language discussed in our Annual Report on Form 10-K for our fiscal year ended June 30, 2011.

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

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

Table of Contents

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

Critical Accounting Estimates and Judgments

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

Revenue Recognition

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

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

Warranties

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

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

Inventories

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

Table of Contents

Accounts Receivable

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

Long-lived Assets

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

Stock-Based Compensation

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

The determination of fair value using the Black-Scholes model is affected by our stock price as well as assumptions regarding a number of complex and subjective variables, including expected stock price volatility, risk-free interest rate, expected dividends and projected employee stock option exercise behavior. We currently estimate stock price volatility based upon historical activity, with future volatility expected to approximate past volatility. The expected time to exercise is based on a simplified model of the vesting term of the option plus one-half the option life.

Income Taxes

We recognize deferred tax assets and liabilities for temporary differences between the financial reporting basis and the tax basis of our assets and liabilities along with net operating loss and tax credit carryovers. Deferred tax assets at December 31 and June 30, 2011 consisted primarily of basis differences related to research and development tax credit utilization, intangible assets, accrued expenses and inventories.

Significant management judgment is required in determining our provision for income taxes and the recoverability of our deferred tax assets. Such determination is based on our historical taxable income, with consideration given to our estimates of future taxable income and the periods over which deferred tax assets will be recoverable. We record a valuation allowance against deferred tax assets to reduce the net carrying value to an amount that we believe is more likely than not to be realized. When we establish or reduce the valuation allowance against deferred tax assets, the provision for income taxes will increase or decrease, respectively, in the period such determination is made. At December 31 and June 30, 2011, we maintained a valuation allowance against the entire balance of our deferred tax assets, net of deferred tax liabilities.

Table of Contents**Description of Business**

The majority of our revenue is derived from designing, developing and manufacturing surgical devices for the medical device and dental industries, fractional horsepower motors for aerospace, medical and military applications, and motion control software and hardware for industrial and scientific applications. The proportion of total sales by customer type is as follows:

| Customer type | Three months ended December 31, | | | | Six months ended December 31, | | | |
|----------------------|--|-------------|-----------------|-------------|--------------------------------------|-------------|------------------|-------------|
| | 2011 | | 2010 | | 2011 | | 2010 | |
| | (Dollars in thousands) | | | | (Dollars in thousands) | | | |
| Medical | \$ 3,033 | 62% | \$ 3,973 | 65% | \$ 7,246 | 66% | \$ 7,766 | 65% |
| Aerospace | 821 | 17% | 803 | 13% | 1,636 | 15% | 1,405 | 12% |
| Industrial | 772 | 16% | 703 | 11% | 1,415 | 13% | 1,600 | 13% |
| Dental | 216 | 4% | 602 | 10% | 480 | 4% | 1,037 | 9% |
| Government and other | 65 | 1% | 76 | 1% | 160 | 2% | 178 | 1% |
| Total sales | \$ 4,907 | 100% | \$ 6,157 | 100% | \$ 10,937 | 100% | \$ 11,986 | 100% |

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

We are generally able to fill orders for recurring product within 60 days from initial order receipt. At December 31, 2011, we had a backlog, including orders for delivery beyond 60 days, of \$9.3 million. We may experience variability in our new order bookings due to various reasons, including, but not limited to, the timing of major new product launches and customer planned inventory builds. However, we do not typically experience seasonal fluctuations in our shipments and revenues.

Table of Contents**RESULTS OF OPERATIONS****Comparison of the three-month periods ended December 31, 2011 and 2010**

The following table sets forth certain financial data for the three months ended December 31, 2011 and 2010:

| | Three Months Ended December 31, | | | |
|---|---------------------------------|----------------------|----------|------|
| | 2011 | Dollars in thousands | | 2010 |
| Net sales | \$ 4,907 | 100% | \$ 6,157 | 100% |
| Cost of sales | 3,504 | 71% | 3,733 | 61% |
| Gross profit | 1,403 | 29% | 2,424 | 39% |
| Selling | 369 | 8% | 351 | 6% |
| General and administrative expenses | 709 | 15% | 897 | 14% |
| Research and development costs | 607 | 12% | 605 | 10% |
| Income (loss) from operations | (282) | -6% | 571 | 9% |
| Interest expense and other, net | (9) | 0% | (22) | 0% |
| Income (loss) before provision for income taxes | (291) | -6% | 549 | 9% |
| Provision for income taxes | 1 | 0% | 148 | 2% |
| Net income (loss) | \$ (292) | -6% | \$ 401 | 7% |

Net sales for the three months ended December 31, 2011 decreased \$1,250,000, or 20%, to \$4,907,000 from \$6,157,000 for the three months ended December 31, 2010, due primarily to a decrease in sales of our medical device products to our largest customer, amounting to \$783,000, and to decreases in sales of our dental products aggregating \$386,000.

Gross profit for the three months ended December 31, 2011 decreased \$1,021,000 or 42% compared to the corresponding period in 2010. Gross profit as a percentage of sales decreased 10 percentage points to 29% for the three months ended December 31, 2011, compared to 39% for the three months ended December 31, 2010. These decreases resulted primarily from (a) the sales volume decreases discussed above, (b) higher warranty expenses, due to an increase in the estimated per-unit warranty repair costs during the three months ended December 31, 2011 relative to the corresponding period in 2010, and (c) reduced manufacturing efficiencies associated with the lower sales volume, which decreased gross profit for the three months ended December 31, 2011 from the corresponding period in 2010, by \$705,000, \$198,000 and \$93,000, respectively.

Selling expenses increased \$18,000, or 5%, to \$369,000 for the three months ended December 31, 2011, from \$351,000 for the corresponding period in 2010. This increase is attributable primarily to increases in advertising and trade show expenses of \$50,000 and \$18,000, respectively, from 2010 to 2011, partially offset by a decrease in website development costs, of \$51,000, from 2010 to 2011.

General and administrative expenses decreased \$188,000, or 21%, to \$709,000 for the three months ended December 31, 2011, from \$897,000 for the corresponding period in 2010, due primarily to decreases in 2011 related to employee compensation and corporate legal expense, which decreases amounted to \$135,000 and \$55,000, respectively.

Research and development costs, which include costs related to development of new products and enhancements to existing products, were relatively unchanged, increasing to \$607,000 for the three months ended December 31, 2011 from \$605,000 for the three months ended December 31, 2010.

Table of Contents

As a result of the foregoing, operating loss for the three months ended December 31, 2011 was \$282,000 compared to operating income of \$571,000 for the corresponding period in 2010.

Net interest expense for the three months ended December 31, 2011 was \$9,000 compared to \$22,000 for the three months ended December 31, 2010. This decrease is due to the effect of the refinancing of our bank term loan in February 2011 (see Note 5 of Notes to Condensed Consolidated Financial Statements).

Provision For Income Taxes. Our estimated effective combined federal and state tax rate on income (loss) from operations was less than 1% for the three months ended December 31, 2011 and 27% for the three-month period ended December 31, 2010. These effective rates are lower than marginal statutory rates due to the utilization of tax credits, previously established as deferred tax assets, to reduce the current tax provision. Because our deferred tax assets are fully reserved by a valuation allowance, realization of such deferred tax assets triggered a corresponding reduction in the valuation allowance, thus resulting in no deferred tax provision (see Note 6 of Notes to Condensed Consolidated Financial Statements).

As a result of the foregoing, net loss for the three months ended December 31, 2011 was \$292,000, or \$0.09 per share on a basic and diluted basis, as compared to net income of \$401,000, or \$0.12 per share on a basic and diluted basis, for the three months ended December 31, 2010.

Comparison of the six-month periods ended December 31, 2011 and 2010

The following table sets forth the periods indicated and the percentage of net revenues represented by each item in our Consolidated Statements of Operations.

| | For the six months ended December 31, | | | |
|--|---------------------------------------|------|-----------|------|
| | 2011 | | 2010 | |
| | Dollars in thousands | | | |
| Net sales | \$ 10,937 | 100% | \$ 11,986 | 100% |
| Cost of sales | 7,205 | 66% | 7,378 | 62% |
| Gross profit | 3,732 | 34% | 4,608 | 38% |
| Selling | 743 | 7% | 775 | 6% |
| General and administrative expenses | 1,544 | 14% | 1,660 | 14% |
| Research and development costs | 1,269 | 12% | 1,196 | 10% |
| Income from operations | 176 | 1% | 977 | 8% |
| Net interest and other expense | (20) | 0% | (80) | -1% |
| Income before provision for income taxes | 156 | 1% | 897 | 7% |
| Provision for income taxes | 2 | 0% | 154 | 1% |
| Net income | \$ 154 | 1% | \$ 743 | 6% |

Net sales for the six months ended December 31, 2011 decreased \$1,049,000, or 9%, to \$10,937,000 from \$11,986,000 for the six months ended December 31, 2010. Contributing to this decrease was (a) a reduction, amounting to \$1.2 million, in sales of our medical device products to our largest customer, offset by an increase, amounting to \$1.3 million, in sales of medical device

Table of Contents

products to our second largest customer, (b) a net decrease, amounting to \$628,000, in sales of our medical device products to other customers, and (c) a decrease, amounting to \$557,000, in sales of our dental products.

Gross profit for the six months ended December 31, 2011 decreased \$876,000, or 19%, compared to the corresponding period in 2010. Gross profit as a percentage of sales decreased 4 percentage points to 34% for the six months ended December 31, 2011, compared to 38% for the six months ended December 31, 2010. These decreases resulted primarily from (a) the sales volume decreases discussed above, and (b) higher warranty expenses, due to an increase in the estimated per-unit warranty repair costs during the six months ended December 31, 2011 relative to the corresponding period in 2010, which decreased gross profit for the six months ended December 31, 2011 from the corresponding period in 2010, by \$775,000 and \$328,000, respectively.

Selling expenses decreased \$32,000, or 4%, to \$743,000 for the six months ended December 31, 2011, from \$775,000 for the corresponding period in 2010. This decrease is attributable primarily to reductions in costs related to our website and in employee-related expenses, amounting to \$117,000 and \$40,000, respectively, partially offset by increases for advertising and travel expenses, amounting to \$96,000 and \$30,000, respectively, in the six-month period ended December 31, 2011 from the corresponding period in 2010.

General and administrative expenses decreased \$117,000, or 7%, to \$1,544,000 for the six months ended December 31, 2011, from \$1,660,000 for the corresponding period in 2010, due primarily to decreases in compensation and corporate legal expenses, amounting to \$136,000 and \$68,000, respectively, partially offset by increases, amounting to \$65,000 and \$20,000, in outsourced service and employee stock option expenses, respectively, in the six-month period ended December 31, 2011 from the corresponding period in 2010.

Research and development costs, which include costs related to development of new products and enhancements to existing products, increased \$73,000, or 6%, to \$1,269,000 for the six months ended December 31, 2011, from \$1,196,000 for the six months ended December 31, 2010 due primarily to a \$72,000 increase in small motor development costs.

As a result of the foregoing, operating income for the six months ended December 31, 2011 decreased to \$176,000 compared to \$977,000 for the corresponding period in 2010.

Net interest expense for the six months ended December 31, 2011 was \$20,000 compared to \$80,000 for the six months ended December 31, 2010. The decrease was due to the effects of (a) the refinancing of our bank term loan in February 2011, and (b) the repayment and retirement in September 2010, prior to its maturity, of the mortgage collateralized by the land and building owned in Carson City (see Note 5 of Notes to Condensed Consolidated Financial Statements).

Provision For Income Taxes. Our estimated effective combined federal and state tax rate on income from operations was 1% for the six months ended December 31, 2011, and 17% for the six-month period ended December 31, 2010. These effective rates are lower than marginal statutory rates due to the utilization of tax credits, previously established as deferred tax assets, to reduce the current tax provision. Because our deferred tax assets are fully reserved by a valuation allowance, realization of such deferred tax assets triggered a corresponding reduction in the valuation allowance, thus resulting in no deferred tax provision (see Note 6 of Notes to Condensed Consolidated Financial Statements).

As a result of the foregoing, net income for the six months ended December 31, 2011 was \$154,000, or \$0.05 per share on a basic and diluted basis, as compared to \$743,000, or \$0.23 per share on a basic and diluted basis, for the six months ended December 31, 2010.

Table of Contents**Liquidity and Capital Resources**

The following table presents selected financial information as of December 31 and June 30, 2011:

| | December 31, 2011 | June 30, 2011 |
|--|-------------------|---------------|
| Cash and cash equivalents | \$ 4,267,000 | \$ 4,689,000 |
| Working capital | \$ 7,941,000 | \$ 7,819,000 |
| Cash and cash equivalents, net of bank debt | \$ 3,315,000 | \$ 3,558,000 |
| Tangible book value per common share | \$ 3.21 | \$ 3.15 |
| Number of days of sales outstanding in accounts receivable | 41 | 38 |

During the six months ended December 31, 2011 and 2010, cash and cash equivalents decreased \$422,000 and \$1.8 million, respectively, as a result of the factors described below.

Net cash used in operations during the six months ended December 31, 2011, amounted to \$6,000. Providing cash for operations was net income, adjusted for non-cash items, amounting to \$532,000, and a decrease in accounts receivable, amounting to \$834,000, which was due primarily to the lower level of sales in our normal collection period preceding December 31, 2011, relative to that preceding June 30, 2011. Requiring cash for operations was an increase in inventories, amounting to \$1.0 million, primarily in anticipation of fulfilling orders received from our two largest customers, an increase in prepaid expenses, amounting to \$88,000, attributable to the annual renewal of our commercial insurance policies in September 2011, and a decrease in accounts payable and accrued liabilities, amounting to \$213,000, due primarily to the payment of employee bonuses based on the attainment of pre-determined goals related to fiscal 2011.

During the six months ended December 31, 2010, net cash used in operations amounted to \$58,000. Providing cash for operations was net income, adjusted for non-cash items, amounting to \$1.1 million, and a decrease in accounts receivable of \$148,000. Requiring cash for operations was an increase in inventories of \$678,000, primarily in anticipation of fulfilling orders received from our largest customer, an increase in prepaid expenses of \$30,000, primarily due to the annual renewal of our commercial insurance policies, and a decrease in accounts payable and accrued expenses amounting to \$597,000, due primarily to the payment of employee bonuses.

Net cash used in investing activities during the six months ended December 31, 2011 and 2010, consisted of purchases of equipment amounting to \$237,000 and \$16,000, respectively.

Net cash used in financing activities during the six months ended December 31, 2011 consisted of reductions in the principal balance of our bank term loan, amounting to \$179,000. For the six months ended December 31, 2010, net cash used in financing activities amounted to \$1.7 million and was comprised of principal reductions to the then-existing bank term loan amounting to \$200,000, the payment, in September 2010, of the remaining \$1.5 million balance due on the Union Bank mortgage, fully retiring such indebtedness (see Note 5 of Notes to Condensed Consolidated Financial Statements), net of proceeds amounting to \$27,000 from the exercise of stock options.

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

Potential Reduction in Large Customer Orders

In December 2009, our largest customer informed us that it was in the process of developing, and planned to eventually manufacture, its own surgical devices which are functionally comparable to the products we currently provide to the customer. We have been the exclusive manufacturer of these products since they were developed.

Table of Contents

We currently provide this Customer with two products (Product A and Product B) and repair services for such products. Sales for each of these categories for the three and six months ended December 31, 2011 and 2010 were as follows:

| | Three months ended December 31, 2011 | Six months ended December 31, 2011 | Average % of total | Three months ended December 31, 2010 | Six months ended December 31, 2010 | Average % of total |
|------------------------|--|--|-----------------------|--|--|-----------------------|
| Product A | \$ 157,000 | \$ 950,000 | 18% | \$ 806,000 | \$ 2,447,000 | 40% |
| Product B | 1,340,000 | 2,531,000 | 62% | 1,489,000 | 2,383,000 | 47% |
| Repairs and components | 409,000 | 813,000 | 20% | 394,000 | 642,000 | 13% |
| Total | \$ 1,906,000 | \$ 4,294,000 | 100% | \$ 2,689,000 | \$ 5,472,000 | 100% |

As of January 2, 2012, the Customer had orders of (i) \$784,000 for Product A scheduled for delivery through April 2012 (ii) \$745,000 for Product B scheduled for delivery through February 2012, and (iii) \$400,000 of components scheduled for delivery through April 2012, all of which the Customer has indicated it plans to purchase. However, the Customer has indicated that it does not plan to place further orders with us for these products.

The Customer has indicated that its plan is contingent on several factors, including the registration of the Customer's product in a foreign jurisdiction and the successful completion of its field testing for the product that will replace Product B.

In addition, the Customer indicated that it plans to limit repair requests from us to those Products A and B that are covered by our product warranty, likely reducing, possibly to zero, future repair revenue for out-of-warranty products.

Resulting from the foregoing, revenue attributable to the Customer could decline to zero or a negligible amount by the end of fiscal year 2012.

However, the Customer is not obligated either to abide by the timetables it has communicated to us or to update us as to the status of its current plan. Accordingly, we are unable to know or predict the status of the Customer's plan or initiatives on an ongoing basis. The Customer could accelerate, delay or terminate its transition to its own products at any time and without notice to us, which could have a material impact on our revenues. The identity of the Customer is protected by a confidentiality agreement.

We are continuing to implement steps to identify and capture additional revenue opportunities. There can be no assurance, however, as to either the timing or success of achieving this objective, and it would be our intent to reduce operating costs, if and as necessary, to minimize the impact of a revenue reduction, should it occur. In the event that the Customer's future purchases are reduced beyond the realization of such opportunities or cost reductions, we are likely to experience a material and adverse impact on our business.

Changes in Bank Debt and Credit Facilities

As more fully described above (see Note 5 of Notes to Condensed Consolidated Financial Statements), during the fiscal year ended June 30, 2011, we effected the following changes in our bank debt and credit facility arrangements:

On February 4, 2011, we entered into a credit facility agreement with Union Bank that provides for (a) a revolving credit line of up to \$1.5 million, (b) a non-revolving credit line of up to \$350,000 for the purchase of equipment, and (c) a term loan of \$1.25 million. The proceeds of the term loan were used to pay off in full the Wells Fargo term loan previously outstanding.

Table of Contents

On September 16, 2010, we paid the remaining \$1.5 million balance due on a mortgage previously outstanding with Union Bank, fully retiring such indebtedness.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not applicable.

Item 4T. Controls and Procedures

The Chief Executive Officer and Chief Financial Officer (the principal executive officer and principal financial officer, respectively) conducted an evaluation of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (Exchange Act)). Based on that evaluation as of December 31, 2011, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures are effective.

During the three and six months ended December 31, 2011, there were no changes in our internal controls over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act) that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

PART II

OTHER INFORMATION

Item 1. Legal Proceedings

In February 2011, we became aware of a report entitled Site Discovery Report, Southeast Santa Ana Project DTSC Cypress Region, dated February 2010 (the Report), that was prepared by the Cypress regional office of the Cal/EPA Department of Toxic Substances Control (DTSC) for Region 9 of the U.S. Environmental Protection Agency (USEPA) under an agreement between the two agencies. The purpose of the Report was to identify sites within an area of southeast Santa Ana, California that may be sources of groundwater contamination previously detected in that area. The Report identified 25 sites, including our former Santa Ana site, for further screening by DTSC staff over the next two years. DTSC has informed us that no further evaluation of our former site took place during fiscal year 2011, and that it has decided not to evaluate our former site during fiscal year 2012. It is uncertain whether future developments, if any, from DTSC s screening process would have any application to our former site.

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

Table of Contents

Item 1A. Risk Factors.

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for our fiscal year ended June 30, 2011 and in our subsequent quarterly reports on Form 10-Q. The risks discussed in our Annual Report on Form 10-K and in our subsequent quarterly reports on Form 10-Q could materially affect our business, financial condition and future results. The risks described in our Annual Report on Form 10-K and in our subsequent quarterly reports on Form 10-Q are not the only risks facing us. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially and adversely affect our business, financial condition or operating results.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

None.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. [Removed and Reserved.]

Item 5. Other Information.

None.

Item 6. Exhibits.

Exhibits:

- 10.1 Second Amended and Restated 2004 Stock Option Plan
- 10.2 Amended and Restated 2004 Directors Stock Option Plan
- 31.1 Certification of Chief Executive Officer Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of Chief Financial Officer Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32 Certification of the Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 101.INS** XBRL Instance Document
- 101.SCH** XBRL Taxonomy Extension Schema Document
- 101.CAL** XBRL Taxonomy Extension Calculation Linkbase Document
- 101.LAB** XBRL Taxonomy Extension Label Linkbase Document
- 101.PRE** XBRL Taxonomy Extension Presentation Linkbase Document

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

Table of Contents

SIGNATURES

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

Date: February 6, 2012

PRO-DEX INC.

By: / s / Mark Murphy

Mark Murphy

Chief Executive Officer

(Principal Executive Officer)

Date: February 6, 2012

PRO-DEX INC.

By: / s / Harold A. Hurwitz

Harold A. Hurwitz

Secretary and Chief Financial Officer

(Principal Financial and Accounting Officer)