

PRO DEX INC  
Form 10-Q  
February 10, 2015

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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, 2014

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)

COLORADO  
(State or other jurisdiction  
of incorporation or organization)

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

2361 McGaw Avenue, Irvine, California 92614  
(Address of principal executive offices and zip code)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if

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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 x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

|                            |                       |                   |                       |                          |                       |                              |                                  |
|----------------------------|-----------------------|-------------------|-----------------------|--------------------------|-----------------------|------------------------------|----------------------------------|
| Large accelerated<br>filer | <input type="radio"/> | Accelerated filer | <input type="radio"/> | Non-accelerated<br>filer | <input type="radio"/> | Smaller reporting<br>company | <input checked="" type="radio"/> |
|----------------------------|-----------------------|-------------------|-----------------------|--------------------------|-----------------------|------------------------------|----------------------------------|

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

Indicate the number of shares outstanding of each of the Registrant's classes of Common Stock outstanding as of the latest practicable date: 4,169,481 shares of Common Stock, no par value, as of February 3, 2015.

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PRO-DEX, INC. AND SUBSIDIARIES  
 QUARTERLY REPORT ON FORM 10-Q  
 FOR THE THREE AND SIX MONTHS ENDED DECEMBER 31, 2014

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## PART I — FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## PRO-DEX, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands, except share amounts)

|   | December<br>31,<br>2014 | June 30,<br>2014 |
|---|-------------------------|------------------|
| <b>ASSETS</b>   |                         |                  |
| Current Assets:   |                         |                  |
| Cash and cash equivalents   | \$ 1,973                | \$3,188          |
| Accounts receivable, net of allowance for doubtful accounts of \$26 and \$29, respectively  | 1,115                   | 1,776            |
| Unbilled receivables  | 1,415                   | 1,073            |
| Other current receivables   | 22                      | 31               |
| Inventory   | 2,880                   | 2,600            |
| Prepaid expenses  | 211                     | 110              |
| Notes receivable  | 1,205                   | —                |
| Deferred income taxes   | 146                     | 115              |
| Total current assets  | 8,967                   | 8,893            |
| Investments   | 1,002                   | 1,058            |
| Equipment and leasehold improvements, net   | 1,562                   | 1,575            |
| Intangibles   | 334                     | 105              |
| Other assets  | 80                      | 77               |
| Total assets  | \$ 11,945               | \$ 11,708        |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |                         |                  |
| Current Liabilities:  |                         |                  |
| Accounts payable  | \$ 830                  | \$ 744           |
| Accrued expenses  | 1,352                   | 1,090            |
| Deferred revenue  | 501                     | 232              |
| Income taxes payable  | —                       | 53               |
| Capital lease obligations   | 11                      | 8                |
| Total current liabilities   | 2,694                   | 2,127            |
| Deferred income taxes   | 146                     | 115              |
| Deferred rent   | 221                     | 243              |
| Capital lease obligations, net of current portion   | 1                       | 7                |
| Total non-current liabilities   | 368                     | 365              |
| Total liabilities   | 3,062                   | 2,492            |
| Shareholders' equity:   |                         |                  |
| Common shares; no par value; 50,000,000 shares authorized; 4,169,481 and 4,211,019 shares issued and outstanding at December 31, 2014 and June 30, 2014, respectively | 18,497                  | 18,582           |
| Accumulated other comprehensive income  | 316                     | 202              |

|  |           |           |
|--|-----------|-----------|
| Accumulated deficit                        | (9,930 )  | (9,568 )  |
| Total shareholders' equity                 | 8,883     | 9,216     |
| Total liabilities and shareholders' equity | \$ 11,945 | \$ 11,708 |

The accompanying notes are an integral part of these condensed consolidated financial statements.

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**PRO-DEX, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****AND COMPREHENSIVE INCOME (LOSS)****(Unaudited)****(In thousands, except per share amounts)**

|   | Three Months<br>Ended<br>December 31,<br>2014 |           | Six Months<br>Ended<br>December 31,<br>2014 |           |
|---|---|-----------|---|-----------|
|   | 2014  | 2013      | 2014  | 2013      |
| Net sales   | \$2,792                                       | \$2,640   | \$5,387                                     | \$5,194   |
| Cost of sales   | 2,096   | 2,091     | 3,863                                       | 3,700     |
| Gross profit  | 696   | 549       | 1,524                                       | 1,494     |
| Operating expenses:   |   |           |   |           |
| Selling expenses  | 186   | 139       | 328   | 231       |
| General and administrative expenses                           | 459   | 422       | 950   | 878       |
| Research and development costs                                | 444   | 364       | 829   | 740       |
| Total operating expenses                                      | 1,089   | 925       | 2,107                                       | 1,849     |
| Operating loss  | (393 )  | (376 )    | (583 )                                      | (355 )    |
| Interest expense  | (2 )  | (2 )      | (3 )  | (4 )      |
| Interest income   | 4   | 10        | 5   | 10        |
| Gain (loss) from disposal of equipment                        | 1   | (6 )      | 1   | (6 )      |
| Realized gain on sale of investments                          | 59  | —         | 59  | —         |
| Loss from continuing operations before income taxes           | (331 )  | (374 )    | (521 )                                      | (355 )    |
| Income tax benefit  | 129   | 36        | 138   | 35        |
| Loss from continuing operations                               | (202 )  | (338 )    | (383 )                                      | (320 )    |
| Income from discontinued operations,<br>net of income taxes   | 10  | —         | 21  | 194       |
| Net loss  | \$(192 )                                      | \$(338 )  | \$(362 )                                    | \$(126 )  |
| Other comprehensive income, net of tax:                       |   |           |   |           |
| Unrealized gain from marketable equity investments            | 162   | 148       | 173   | 204       |
| Less: Reclassification of realized gains included in net loss | (59 )   | —         | (59 )                                       | —         |
| Comprehensive income (loss)                                   | \$(89 )                                       | \$(190 )  | \$(248 )                                    | \$78      |
| Basic and diluted net loss per share:                         |   |           |   |           |
| Loss from continuing operations                               | \$(0.05 )                                     | \$(0.10 ) | \$(0.09 )                                   | \$(0.10 ) |
| Income from discontinued operations                           | —   | —         | —   | 0.06      |

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|   |       |       |       |       |
|---|-------|-------|-------|-------|
| Net loss                                    |       |       |       |       |
|   |       |       |       |       |
| Weighted average common shares outstanding: |       |       |       |       |
| Basic                                       | 4,170 | 3,343 | 4,190 | 3,344 |
| Diluted                                     | 4,170 | 3,343 | 4,190 | 3,344 |
| Common shares outstanding                   | 4,170 | 3,343 | 4,170 | 3,344 |

The accompanying notes are an integral part of these condensed consolidated financial statements.

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## PRO-DEX, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)

|  | Six Months<br>Ended<br>December 31, |          |
|--|-------------------------------------|----------|
|  | 2014                                | 2013     |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>   |                                     |          |
| Net loss   | \$(362 )                            | \$(126 ) |
| Adjustments to reconcile net loss to<br>net cash provided by (used in) operating activities: |                                     |          |
| Depreciation and amortization  | 259                                 | 283      |
| Gain on sale of investments  | (59 )                               | —        |
| Gain on sale of real estate held for sale  | —                                   | (167 )   |
| Loss (gain) on retirement of equipment   | (1 )                                | 6        |
| Share-based compensation   | 11                                  | 31       |
| Deferred income tax benefit  | 77                                  | —        |
| Allowance for doubtful accounts receivable   | (3 )                                | 7        |
| Changes in operating assets and liabilities:   |                                     |          |
| Accounts receivable and other current receivables  | 673                                 | (259 )   |
| Unbilled receivables   | (342 )                              | (367 )   |
| Inventory  | (275 )                              | 282      |
| Prepaid expenses and other assets  | (103 )                              | (8 )     |
| Accounts payable, accrued expenses and deferred rent   | 326                                 | (422 )   |
| Deferred revenue   | 269                                 | 106      |
| Income taxes payable   | (53 )                               | (6 )     |
| Net cash provided by (used in) operating activities  | 263                                 | (640 )   |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>   |                                     |          |
| Purchases of investments   | (12 )                               | (329 )   |
| Purchases of equipment and leasehold improvements  | (209 )                              | (19 )    |
| Acquisition of Huber Precision   | (209 )                              | —        |
| Purchase of notes receivable   | (1,205)                             | —        |
| Proceeds from sale of real estate held for sale  | —                                   | 900      |
| Proceeds from sale of equipment  | 1                                   | 4        |
| Proceeds from sale of investments  | 318                                 | —        |
| Increase in intangibles  | (61 )                               | (40 )    |
| Net cash provided by (used in) investing activities  | (1,377)                             | 516      |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>   |                                     |          |
| Purchase of common stock   | (94 )                               | —        |
| Payments made for common stock rights offering   | (3 )                                | —        |
| Principal payments on capital lease  | (4 )                                | (2 )     |

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|  |         |         |
|--|---------|---------|
| Net cash used in financing activities          | (101 )  | (2 )    |
| Net decrease in cash and cash equivalents      | (1,215) | (126 )  |
| Cash and cash equivalents, beginning of period | 3,188   | 1,680   |
| Cash and cash equivalents, end of period       | \$1,973 | \$1,554 |

Supplemental disclosures of cash flow information:

Cash paid during the period for:

|              |     |     |
|--------------|-----|-----|
| Interest     | \$3 | \$4 |
| Income taxes | \$8 | \$7 |

The accompanying notes are an integral part of these condensed consolidated financial statements.

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PRO-DEX, INC. AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED)

**NOTE 1. BASIS OF PRESENTATION**

The accompanying unaudited condensed consolidated financial statements of Pro-Dex, Inc. (“we”, “us”, “our”, “Pro-Dex” or the “Company”) have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Regulation S-K. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. These financial statements should be read in conjunction with the consolidated financial statements presented in our Annual Report on Form 10-K for the fiscal year ended June 30, 2014. 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, 2014.

Recent Accounting Standards

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

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

Reclassifications

Certain prior period balances have been reclassified to conform to the current period presentation. The reclassifications have no effect on previously reported results of operations or accumulated deficit.

## **NOTE 2. HUBER PRECISION BUSINESS ACQUISITION**

As previously disclosed on Form 8-K filed with the Securities and Exchange Commission (“SEC”) on December 4, 2014, we completed the acquisition of Huber Precision (“Huber”), a manufacturer of machined parts, primarily for the oil and electronics industry on December 1, 2014. The aggregate purchase price paid was \$209,000.

We have accounted for this acquisition as a business combination. This method requires, among other things, that assets acquired and liabilities assumed in a business combination be recognized at their fair values as of the acquisition date. There were no liabilities assumed as part of the Huber acquisition. Pro forma historical results of operations related to the Huber acquisition during the six months ended December 31, 2014 have not been presented because they are not material to our condensed consolidated statements of operations and comprehensive income (loss). The results of operations related to the company acquired have been included in the Company’s consolidated statements of operations since the date Huber was acquired. For the period from December 1, 2014 to December 31, 2014, the revenues and earnings of Huber were not material.

The following table summarizes the allocation of the fair values of the assets acquired (in thousands):

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PRO-DEX, INC. AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

|                         | December<br>31,<br>2014 |
|-------------------------|-------------------------|
| Inventory               | \$ 5                    |
| Fixed Assets            | 37                      |
| Covenant not to compete | 30                      |
| Customer list           | 137                     |
| Total purchase price    | \$ 209                  |

**NOTE 3. COMPOSITION OF CERTAIN FINANCIAL STATEMENT ITEMS**

**Inventory**

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

|                                    | December<br>31,<br>2014 | June<br>30,<br>2014 |
|------------------------------------|-------------------------|---------------------|
| Raw materials/purchased components | \$ 1,055                | \$878               |
| Work in process                    | 725                     | 525                 |
| Sub-assemblies/finished components | 881                     | 823                 |
| Finished goods                     | 219                     | 374                 |
| Total inventory                    | \$ 2,880                | \$2,600             |

**Investments**

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

|                              | December<br>31,<br>2014 | June<br>30,<br>2014 |
|------------------------------|-------------------------|---------------------|
| Marketable equity securities | \$ 1,002                | \$1,058             |

Investments at December 31, 2014 and June 30, 2014 had an aggregate cost basis of \$609,000 and \$857,000, respectively, gross unrealized gains aggregating \$393,000 and \$209,000, respectively, and unrealized losses of \$0 and \$7,000, respectively.

During the three and six months ended December 31, 2014, we sold certain of our investments in marketable equity securities of publicly held companies and recorded realized gains of \$59,000.

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PRO-DEX, INC. AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

**Intangibles**

Intangibles consist of the following (in thousands):

|  | December<br>31,<br>2014 | June<br>30,<br>2014 |
|--|-------------------------|---------------------|
| Capitalized software development costs | \$ 73                   | \$37                |
| Covenant not to compete                | 30                      | —                   |
| Customer list                          | 137                     | —                   |
| Patent-related costs                   | 94                      | 68                  |
| Total intangibles                      | \$ 334                  | \$105               |

Capitalized software development costs relate to internally developed software, which will be amortized over the estimated product life of the underlying product currently in development. Both the covenant not to compete and the customer list relate to assets acquired in conjunction with the purchase of Huber, which closed on December 1, 2014, and will be amortized over five and ten years, respectively. Patent-related costs consist of legal fees incurred in connection with patent applications, and will be amortized over the life of the applicable patent upon its issuance.

**NOTE 4. 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, 2014 and June 30, 2014, the warranty reserve related to continuing operations amounted to \$332,000 and \$237,000, respectively. Warranty expenses are included in cost of sales in the accompanying consolidated statements of operations. Changes in estimates to previously established warranty accruals result from current period updates to assumptions regarding repair costs and warranty return rates, and are included in current period warranty expense. Warranty expense relating to new product sales and changes to estimates for the three months ended December 31, 2014 and 2013 was \$155,000 and \$16,000, respectively, and for the six months ended December 31, 2014 and 2013 was \$150,000 and \$29,000, respectively.

Information regarding the accrual for warranty costs for the three and six months ended December 31, 2014 and 2013 are as follows (in thousands):

|  | As of and for<br>the<br>Three<br>Months<br>Ended<br>December<br>31,<br>2014 2013 |       |
|--|--|-------|
| Beginning balance                                      | \$213  | \$229 |
| Accruals during the period                             | 79   | 47    |
| Changes in estimates of prior period warranty accruals | 76   | (31 ) |
| Warranty amortization                                  | (36 )  | (45 ) |
| Ending balance   | \$332  | \$200 |

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PRO-DEX, INC. AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

|  | As of and for<br>the<br>Six Months<br>Ended<br>December 31,<br>2014 2013 |       |
|--|--|-------|
| Beginning balance                                      | \$237  | \$321 |
| Accruals during the period                             | 150  | 96    |
| Changes in estimates of prior period warranty accruals | —  | (67 ) |
| Warranty amortization                                  | (55 )  | (150) |
| Ending balance   | \$332  | \$200 |

**NOTE 5. NET LOSS PER SHARE**

The Company calculates basic net earnings (loss) per share by dividing net income (loss) by the weighted-average number of common shares outstanding during the reporting period. Diluted earnings (loss) per share reflects the effects of potentially dilutive securities, which consist entirely of outstanding stock options.

Potential common shares of 27,683 and 32,721 have been excluded from diluted weighted average common shares for the three months ended December 31, 2014 and 2013, as the effect would have been anti-dilutive. Similarly, potential common shares of 23,399 and 20,462 have been excluded from diluted weighted average common shares for the six months ended December 31, 2014 and 2013, as the effect would have been anti-dilutive.

The following table presents reconciliations of the numerators and denominators of the basic and diluted earnings (loss) per share computations for net income (loss). In the tables below, income (loss) amounts represent the numerator, and share amounts represent the denominator (in thousands, except per share amounts):

|                                     | Three Months<br>Ended<br>December 31,<br>2014 2013 |          | Six Months<br>Ended<br>December 31,<br>2014 2013 |          |
|-------------------------------------|--|----------|--|----------|
| Basic & Diluted:                    |  |          |  |          |
| Loss from continuing operations     | \$(202 )   | \$(338 ) | \$(383 )   | \$(320 ) |
| Weighted average shares outstanding | 4,170  | 3,343    | 4,190  | 3,344    |

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|   |            |            |            |            |
|---|------------|------------|------------|------------|
| Basic and diluted loss per share from continuing operations       | \$ (0.05 ) | \$ (0.10 ) | \$ (0.09 ) | \$ (0.10 ) |
| Income from discontinued operations                               | \$ 10      | \$ —       | \$ 21      | \$ 194     |
| Weighted average shares outstanding                               | 4,170      | 3,343      | 4,190      | 3,344      |
| Basic and diluted earnings per share from discontinued operations | \$ 0.00    | \$ 0.00    | \$ 0.00    | \$ 0.06    |
| Net loss  | \$ (192 )  | \$ (338 )  | \$ (362 )  | \$ (126 )  |
| Weighted average shares outstanding                               | 4,170      | 3,343      | 4,190      | 3,344      |
| Basic and diluted loss per share                                  | \$ (0.05 ) | \$ (0.10 ) | \$ (0.09 ) | \$ (0.04 ) |

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PRO-DEX, INC. AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED)

**NOTE 6. NOTES RECEIVABLE**

In November 2014, we purchased two promissory notes through a Loan Purchase and Sale Agreement in the amount of \$1.2 million. The promissory notes are cross-collateralized and secured by (collectively, the “Collateral”), among other things, real property consisting of 2.3 acres of land and an approximate 30,000 square foot industrial building and a security interest in substantially all of the assets of Riverside Manufacturing, Inc. (“Riverside”) (consisting primarily of machine shop equipment and accounts receivable).

The notes are recorded at their purchase price and since the notes remain in default, they have been placed on nonaccrual status, meaning there is no accrual for interest earnings. No interest has been collected or recognized since the date of purchase. Due to uncertainties relating to future cash flows projected to be received on the notes, no accretable yield has been recorded.

The Company is currently preparing forbearance agreements and evaluating its options with respect to this investment.

**NOTE 7. DISCONTINUED OPERATIONS AND REAL ESTATE HELD FOR SALE**

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

Under the terms of the APA, we may receive earnout payments based on revenues generated from the sale of (i) Astromec products and (ii) MTI products to Astromec prospects (defined in the APA) (collectively, the “Earnout Sales Base”). Such earnout payments, if and when earned, are paid by MTI to us within 30 days following the end of each of our fiscal quarters during the three years subsequent to the February 2012 closing date, and amount to 6%, 4% and 2% of the Earnout Sales Base in the first, second and third such years, respectively. The earnout payments are recognized in the quarter in which we become entitled to receive them. We recognized income from earnout payments of \$21,000 and \$41,000 for the three months ended December 31, 2014 and 2013, respectively, and \$42,000 and \$70,000 for the six months ended December 31, 2014 and 2013, respectively. We have recognized an aggregate of \$393,000 in income from such earnout payments since the February 2012 closing date.

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

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PRO-DEX, INC. AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

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

|  |  |  | Three<br>Months<br>Ended<br>December<br>31,<br>2014 | 2013 |
|--|--|--|---|------|
| Revenues   |  |  | \$21  | \$41 |
| Income before provision for income taxes of \$7,000 and \$36,000, respectively |  |  | \$17  | \$36 |

|   |  |  | Six Months<br>Ended<br>December<br>31,<br>2014 | 2013  |
|---|--|--|--|-------|
| Revenues  |  |  | \$42   | \$70  |
| Income before provision for income taxes of \$14,000 and \$36,000, respectively |  |  | \$35   | \$230 |

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

|                     |    |    | December<br>31,<br>2014 | June<br>30,<br>2014 |
|---------------------|----|----|-------------------------|---------------------|
| Accounts receivable | \$ | 21 | \$                      | 17                  |
| Prepaid expenses    | \$ | 11 | \$                      | 3                   |
| Accrued expenses    | \$ | 2  | \$                      | 2                   |

**NOTE 8. 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 or loss, with some consideration given to our estimates of future taxable income or loss by jurisdictions in which we operate and the period over which our deferred tax assets would be recoverable. Due to cumulative taxable losses during the past three years, we maintained a valuation allowance of \$3.7 million against our deferred tax assets as of December 31, 2014.

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As of December 31, 2014, we have accrued \$385,000 of unrecognized tax benefits related to federal and state income tax matters. None of this balance is expected to reduce the Company's income tax expense if recognized.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows (in thousands):

|  |        |
|--|--------|
| Balance at July 1, 2014                                      | \$ 363 |
| Additions based on tax positions related to the current year | 22     |
| Reductions for tax positions of prior years                  | —      |
| Balance at December 31, 2014                                 | \$ 385 |

We recognize accrued interest and penalties related to unrecognized tax benefits when applicable. As of December 31, 2014, no interest or penalties applicable to our unrecognized tax benefits have been accrued since we have sufficient tax attributes available to fully offset any potential assessment of additional tax.

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, 2011 and later. Our state income tax returns are open to audit under the statute of limitations for the years ended June 30, 2010 and later. We do not anticipate a significant change to the total amount of unrecognized tax benefits within the next 12 months.

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**NOTE 9. COMMON STOCK**

**Rights Offering**

On December 17, 2013, we publicly announced plans to complete a rights offering to existing holders of our common stock, and we commenced the rights offering on March 24, 2014, pursuant to a registration statement on Form S-3 filed with the SEC. The rights offering was made through the distribution to our existing shareholders as of March 20, 2014 of non-transferable subscription rights to purchase their pro rata portion of newly issued shares of our common stock (the "Subscription Privilege") at a price of \$1.90 per share (the "Subscription Price"). The subscription period for exercise of the rights commenced on March 24, 2014 and expired on April 25, 2014.

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

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

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

In the event that the exercise by a shareholder of the Subscription Privilege or the purchase of our common stock under the Standby Purchase Agreement could, in our sole discretion, have potentially resulted in a limitation of our ability to utilize our tax attributes, such as the annual utilization of net operating loss or tax credit carry forwards (see



Note 8), we had the ability to reduce the exercise by such shareholder of the Subscription Privilege or the amount purchased under the Standby Purchase Agreement to such number of shares of our common stock as we determined advisable in order to preserve our ability to utilize such tax attributes. On the basis of the Company's analysis of tax attributes, the Company did not reduce the subscriptions of any shareholder in the rights offering, but did reduce to zero the number of shares the Standby Purchasers could have otherwise purchased pursuant to the Standby Purchase Agreement. As a result, no shares were issued to AO Partners, LLC or Farnam Street Capital, Inc. pursuant to the Standby Purchase Agreement.

The proceeds from the rights offering have been used to invest in the notes receivable more fully described in Note 6 above. Additionally during the second quarter, as described in Note 2 above, we acquired Huber, for an aggregate purchase price of approximately \$209,000.

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### Share Repurchase Program

In September 2013, our Board approved a share repurchase program authorizing the Company to repurchase up to 750,000 shares of our common stock. In accordance with, and as part of, this share repurchase program, our Board approved, on September 23, 2014, the adoption of a prearranged share repurchase plan intended to qualify for the safe harbor under Rule 10b5-1 under the Securities Exchange Act of 1934, as amended (“10b5-1 Plan”). The 10b5-1 Plan became effective on September 24, 2014 and terminates on March 23, 2015, unless terminated sooner in accordance with its terms. Through December 31, 2014, we repurchased 41,538 shares at an aggregate cost of \$94,000, inclusive of fees, under the terms of the 10b5-1 Plan. Repurchases under the 10b5-1 Plan are administered through an independent broker.

### NOTE 10. SHARE-BASED COMPENSATION

As discussed further below, until June 2014 we had two equity compensation plans, the Second Amended and Restated 2004 Stock Option Plan (the “Employee Stock Option Plan”) and the Amended and Restated 2004 Directors’ Stock Option Plan (the “Directors’ Stock Option Plan”) (collectively, the “Stock Option Plans”), pursuant to which (i) options to purchase shares of common stock, or (ii) restricted shares of common stock, could be granted up to an aggregate amount of 1,333,333 common shares, with 1,066,667 and 266,666 shares distributed between the Employee Stock Option Plan and the Directors’ Stock Option Plan, respectively. The Stock Option Plans were substantially similar, providing for a strike price equal to the closing price for a share of our common stock as of the last business day immediately prior to the grant date, vesting periods as determined by the Board for the Employee Stock Option Plan and six months for the Directors’ Stock Option Plan, and terms of up to ten years, subject to forfeit 30 days after the holder ceases to be an employee or 90 days after the holder ceases to be a director, as the case may be. Share-based compensation expense under the Stock Option Plans for the three months ended December 31, 2014 and 2013 was \$4,000 and \$12,000, respectively, and for the six months ended December 31, 2014 and 2013 was \$11,000 and 31,000, respectively.

### Stock Options

As of December 31, 2014, there was an aggregate of \$4,000 of unrecognized compensation cost under the Stock Option Plans related to 6,667 non-vested outstanding stock options with a per share weighted average value of \$1.98. The unrecognized expense is anticipated to be recognized on a straight-line basis over a weighted average period of 8.3 months. Following is a summary of stock option activity for the six months ended December 31, 2014 and 2013:

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|   | 2014             |                                 | 2013             |                                 |
|---|------------------|---------------------------------|------------------|---------------------------------|
|   | Number of Shares | Weighted-Average Exercise Price | Number of Shares | Weighted-Average Exercise Price |
| Outstanding at July 1,                    | 165,002          | \$ 2.40                         | 292,504          | \$ 2.35                         |
| Options granted                           | —                | —                               | —                | —                               |
| Options exercised                         | —                | —                               | (804 )           | 1.80                            |
| Options forfeited                         | (8,334 )         | 5.58                            | (100,306)        | 2.34                            |
| Outstanding at end of period              | 156,668          | \$ 2.23                         | 191,394          | \$ 2.36                         |
| Stock Options Exercisable at December 31, | 150,001          | \$ 2.26                         | 148,061          | \$ 2.53                         |

No options were granted during the three or six months ended December 31, 2014 and 2013.

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Following is a summary of information regarding options outstanding and options exercisable at December 31, 2014:

| Range of Exercise Prices | Options Outstanding |  |                              | Options Exercisable       |                    |  |                              |                         |
|--------------------------|---------------------|--|------------------------------|---------------------------|--------------------|--|------------------------------|-------------------------|
|                          | Number Outstanding  | Weighted-Avg. Remaining Contractual Life | Weighted-Avg. Exercise Price | Aggregate Intrinsic Value | Number Outstanding | Weighted-Avg. Remaining Contractual Life | Weighted-Avg. Exercise Price | Average Intrinsic Value |
| \$0 to 2.50              | 145,000             | 6.73                                     | \$1.38                       | \$86,650                  | 138,333            | 6.68                                     | \$1.37                       | \$81,000                |
| 2.5 to 5.00              | 3,334               | 2.38                                     | 4.38                         | —                         | 3,334              | 2.38                                     | 4.38                         | —                       |
| 7.51 to 10.00            | 8,334               | 1.02                                     | 7.65                         | —                         | 8,334              | 1.02                                     | 7.65                         | —                       |
| Total                    | 156,668             | 6.70 years                               | \$2.23                       | \$86,650                  | 150,001            | 5.47                                     | \$2.26                       | \$81,000                |

In June 2014, our Board of Directors terminated the Employee Stock Option Plan, with the provision that options outstanding under the Employee Stock Option Plan will remain outstanding in accordance with their respective terms. At the date of termination, 531,381 shares were reserved for issuance under the Employee Stock Option Plan in excess of shares issuable pursuant to outstanding options, all of which shares will be available for issuance under the provisions of the Employee Stock Purchase Plan described below.

In September 2014, our Board approved the inclusion in our proxy statement for approval by our shareholders at the 2014 Annual Meeting of Shareholders its recommendation to terminate the Directors' Stock Option Plan, which proposal was approved by our shareholders at the December 3, 2014 Annual Meeting. At September 30, 2014, 173,334 shares were reserved for issuance under the Directors' Stock Option Plan, all of which, will be available for issuance under the provisions of the Employee Stock Purchase Plan described below.

### Employee Stock Purchase Plan

Also in September 2014, our Board approved the establishment of an Employee Stock Purchase Plan (the "ESPP"). The ESPP conforms to the provisions of Section 423 of the Internal Revenue Code, has coterminous offering and purchase periods of six months, and bases the pricing to purchase shares of our common stock on a formula so as to result in a per share purchase price that approximates a 15% discount from the market price of a share of our common stock at the end of the purchase period. The Board of Directors also approved the provision that shares formerly reserved for issuance under the Employee Stock Option Plan and the Directors' Stock Option Plan in excess of shares issuable pursuant to outstanding options, aggregating 704,715 shares, be reserved for issuance pursuant to the ESPP. The 2014 Employee Stock Purchase Plan was approved by our shareholders at the December 3, 2014 Annual Meeting. On

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February 2, 2015, the Company filed a Registration Statement on Form S-8 registering the 704,715 shares issuable under the ESPP under the Securities Act of 1933.

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**Restricted Stock**

The following is a summary of restricted share activity for the six months ended December 31, 2014 and 2013:

|                                    | 2014                   |  | 2013                   |  |
|------------------------------------|------------------------|--|------------------------|--|
|                                    | Number<br>of<br>Shares | Weighted-Average<br>Grant Date<br>Fair Value | Number<br>of<br>Shares | Weighted-Average<br>Grant Date Fair<br>Value |
| Outstanding at beginning of period | 13,333                 | \$ 1.73                                      | 32,500                 | \$ 1.73                                      |
| Granted                            | —                      | —  | —                      | —  |
| Vested                             | (6,667 )               | 1.73   | (9,166 )               | 1.73   |
| Forfeited                          | —                      | 1.73   | (6,667 )               | 1.73   |
| Outstanding at end of period       | 6,666                  | \$ 1.73                                      | 16,667                 | \$ 1.73                                      |

As of December 31 2014, there was \$6,000 in unrecognized compensation cost related to non-vested outstanding restricted shares. The unrecognized expense is anticipated to be amortized over the next 8.3 months..

**NOTE 11. MAJOR CUSTOMERS**

Information with respect to one customer (“Customer 1”), who accounted for sales in excess of 10% of our total sales in both the three-month periods and the six-month periods ended December 31, 2014 and 2013, is as follows (in thousands, except percentages):

|               | Three Months Ended December<br>31, |         |           |         |
|---------------|------------------------------------|---------|-----------|---------|
|               | 2014                               |         | 2013      |         |
|               | Amount of                          | Percent | Amount of | Percent |
|               | Total                              | Total   | Total     | Total   |
| Total revenue | \$2,792                            | 100%    | \$2,640   | 100%    |

Customer concentration:

|            |         |     |         |     |
|------------|---------|-----|---------|-----|
| Customer 1 | \$1,691 | 61% | \$1,296 | 49% |
|------------|---------|-----|---------|-----|

|  | Six Months Ended December 31, |           |           |           |
|--|-------------------------------|-----------|-----------|-----------|
|  | 2014                          |           | 2013      |           |
|  |                               | Percent   |           | Percent   |
|  | Amount of                     | Amount of | Amount of | Amount of |
|  | Total                         | Total     | Total     | Total     |

|               |         |      |         |      |
|---------------|---------|------|---------|------|
| Total revenue | \$5,387 | 100% | \$5,194 | 100% |
|---------------|---------|------|---------|------|

Customer concentration:

|            |         |     |         |     |
|------------|---------|-----|---------|-----|
| Customer 1 | \$3,198 | 59% | \$2,393 | 46% |
|------------|---------|-----|---------|-----|

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PRO-DEX, INC. AND SUBSIDIARIES  
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Information with respect to Customer 1, accounts receivable from whom comprised more than 10 percent of our gross accounts receivable at December 31, 2014 and June 30, 2014 is as follows (in thousands, except percentages):

|                                 | December 31,<br>2014 |      | June 30, 2014 |      |
|---------------------------------|----------------------|------|---------------|------|
| Total gross accounts receivable | \$1,141              | 100% | \$1,805       | 100% |
| Customer concentration:         |                      |      |               |      |
| Customer 1                      | \$587                | 51%  | \$962         | 53%  |

**NOTE 12. COMMITMENTS AND CONTINGENCIES**

**Legal Matters**

In general, we are from time to time a party to various legal proceedings incidental to our business, none of which we currently 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 13. FAIR VALUE MEASUREMENTS**

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

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



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

Notes Receivable: Notes receivable are classified within Level 3 of the valuation hierarchy for purposes of evaluating potential impairment of these assets. The fair value of the notes receivable is based upon the valuation of a third party appraisal of the building and equipment which is security for the notes less estimates of outstanding property tax liens and other liquidation costs.

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

#### **NOTE 14. SUBSEQUENT EVENTS**

As previously announced, effective January 12, 2015 Harold A. Hurwitz resigned from all of his positions at the Company, including as Chief Executive Officer, President, Chief Financial Officer, Director, Treasurer and Secretary. The Company is in the process of negotiating a separation agreement with Mr. Hurwitz concerning the conclusion of Mr. Hurwitz's services with the Company, the terms of which will be disclosed by the Company if and when entered into with Mr. Hurwitz. On January 12, 2015, the Board appointed Mr. Richard L. Van Kirk to the position of Chief Executive Officer and as a Director to fill the vacancy created by Mr. Hurwitz's resignation and Ms. Alisha K. Charlton to the position of Chief Financial Officer.

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On February 1, 2015, the Company completed the acquisition of substantially all the assets of Fineline Molds, a California corporation (“Fineline”), that is engaged in the manufacture of plastic injection molds serving customers in a variety of industries (the “Acquisition”). The Acquisition was made pursuant to an Asset Purchase Agreement, between the Company and Fineline dated December 8, 2014 ( the “Agreement”), as reported in the Company’s Current Report on Form 8-K filed with the SEC on December 11, 2014 and February 4, 2015.

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## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

*The following discussion and analysis should be read in conjunction with our unaudited interim condensed consolidated financial statements and the related notes and other financial information appearing elsewhere in this report.*

### COMPANY OVERVIEW

The following discussion and analysis provides information that management believes is relevant to an assessment and understanding of the results of operations and financial condition of Pro-Dex, Inc. ("Company", "Pro-Dex", "we", "our" or "us") for the three and six-month periods ended December 31, 2014 and 2013. 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, strategic opportunities 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, competition from larger, better capitalized competitors, and our ability to realize returns on opportunities. 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, 2014.

With operations in California, Michigan and Oregon, we provide products used in medical, research and industrial applications. Experience in surgical devices and multi-axis motion control applications allows us to develop products that require high precision in harsh environments. We also provide engineering consulting and placement services, as well as quality and regulatory consulting services through our Engineering Services Division.

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

marketing purposes as brand names.

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

#### Basis of Presentation

The condensed consolidated results of operation presented in this report are not audited and those results are not necessarily indicative of the results to be expected for the entirety of the fiscal year ending June 30, 2015 or any other interim period during such fiscal year. Our fiscal year ends on June 30 and our fiscal quarters end on September 30, December 31, and March 31. Unless otherwise stated, all dates refer to our fiscal year and those fiscal quarters.

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## 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 and title transfer to the customer and all other conditions required by GAAP, as promulgated by the Financial Accounting Standards Board (“FASB”) in Accounting Standards Codification (“ASC”) Section 605 (formerly Staff Accounting Bulletin No. 104, *Revenue Recognition*), have been satisfied.

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

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

## Estimated Losses on Product Development Services

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

Owing to the complexity of many of the contracts we have undertaken, the cost estimation process requires significant judgment. It is based upon the knowledge and experience of our project managers, engineers, and finance

professionals. Factors that are considered in estimating the cost of work to be completed and ultimate profitability of the fixed price product development portion of development and supply contracts include the nature and complexity of the work to be performed, availability and productivity of labor, the effect of change orders, the availability of materials, performance of subcontractors, and expected costs for specific regulatory approvals.

#### Warranties

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

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

#### Inventory

Inventory is 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 usage over the prior 12 months as well as future demand supported by our materials requirement planning.

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#### Accounts Receivable and Unbilled Receivables

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

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

#### Investments

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

#### Notes Receivable

The notes receivable are accounted for under ASC Section 310-30 "Loans and Debt Securities Acquired with Deteriorated Credit Quality." The notes are recorded at their purchase price and since the notes remain in default, they are considered impaired and have been placed on nonaccrual status, meaning there is no accrual for interest earnings. No interest has been collected or recognized since the date of purchase. Due to uncertainties relating to future cash flows projected to be received on the notes, no accretable yield has been recorded.

The notes are considered impaired because we do not believe the contractual payments will be collected pursuant to contract terms. Accordingly, the recorded investment is reflected at the lesser of the purchase price or the estimated fair value of the collateral (with appropriate reductions for estimated disposal costs). No impairment loss has been recorded as of December 31, 2014.

## Equipment and Leasehold Improvements

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

## Intangibles

Intangibles consist of legal fees incurred in connection with patent applications, capitalized software development costs, covenant not to compete and customer list. The legal fees will be amortized over the life of the applicable patent upon its issuance and the capitalized software development costs will be amortized over the estimated product life of the underlying product currently in development. Both the covenant not to compete and customer list relate to assets acquired in conjunction with the purchase of Huber Precision and will be amortized over five and ten years, respectively.

## Stock-Based Compensation

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

For stock options, fair value is estimated using the Black-Scholes option-pricing model. The portion that is ultimately expected to vest is recognized as compensation cost over the requisite service period using the straight-line single option method.

The determination of fair value using the Black-Scholes model is affected by our stock price as well as assumptions regarding a number of complex and subjective variables, including expected stock price volatility, risk-free interest rate, expected dividends and projected 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.

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## 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, 2014 and June 30, 2014 consisted primarily of basis differences related to research and development tax credit utilization, net operating loss carryovers, intangible assets, accrued expenses and inventory.

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 or loss, with consideration given to our estimates of future taxable income or loss 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, 2014 and June 30, 2014, we maintained a valuation allowance against the entire balance of our deferred tax assets, net of deferred tax liabilities.

## Business Combinations

We allocate the fair value of purchase consideration to the tangible assets acquired, liabilities assumed and intangible assets acquired based on their estimated fair values. The excess of the fair value of purchase consideration over the fair values of these identifiable assets and liabilities is recorded as goodwill. Such valuations require management to make significant estimates and assumptions, especially with respect to intangible assets. Significant estimates in valuing certain intangible assets include, but are not limited to, future expected cash flows, useful lives and discount rates. Management's estimates of fair value are based upon assumptions believed to be reasonable, but which are inherently uncertain and unpredictable and, as a result, actual results may differ from estimates. During the measurement period, which is one year from the acquisition date, we may record adjustments to the assets acquired and liabilities assumed, with the corresponding offset to goodwill. Upon the conclusion of the measurement period, any subsequent adjustments are recorded to earnings.

## Business Strategy and Future Plans

Our business today is almost entirely driven by sales of our medical products and related repair services to our largest customer (accounting for 59% of our fiscal 2015 year-to-date revenue), and we continue to focus a significant percentage of our time and resources on providing outstanding products and service to our valued principal customer.

Simultaneously, we are working to build top-line sales through active proposals of new medical device products with new and existing customers, and anticipate completing two on-going engineering projects during fiscal 2015 which will allow us to realize previously deferred revenue recorded on these projects as well as potential new product sales later in fiscal 2015. Additionally, we are seeking additional revenue streams by offering our engineering, manufacturing and quality systems services to other customers in diverse industries, through our Engineering Services Division (“ESD”). As previously announced, we opened headquarters for ESD in Troy, Michigan and have assembled a talented team of recruiters and sales people both in our Irvine and Troy locations to generate top-line growth.

This fiscal year we acquired two businesses, Huber Precision, which manufactures machined parts for the auto and electronics industries, and Fineline Molds, which manufactures plastic injection molds for companies in a wide variety of industries. We believe these acquisitions will allow us to diversify our product offerings and increase the utilization of our machine and assembly departments.

In addition, during the second quarter of this fiscal year we invested \$1.2 million in notes receivable secured by real property and business assets of a company located in Ramsey, Minnesota. The options under consideration relating to this investment include a complete sale or liquidation to satisfy the claims of the notes, a refinancing or restructuring.

In summary, our current objectives are focused primarily on maintaining our relationship with our current largest customer, expanding our business with new product launches and services related to our areas of expertise, and successfully integrating recent acquisitions that will further diversify our product portfolio while increasing our manufacturing efficiency. However, there can be no assurance that we will be successful in any of these objectives.

## Description of Business Operations

### *Revenue*

The majority of our revenue is derived from designing, developing and manufacturing surgical devices for the medical device and dental industries and motion control software and hardware for industrial and scientific applications. The proportion of total sales by customer type is as follows (in thousands, except percentages):

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|                      | Three Months Ended<br>December 31,<br>2014 |                 | 2013    |                 | Six Months Ended<br>December 31,<br>2014 |                 | 2013    |                 |
|----------------------|--|-----------------|---------|-----------------|--|-----------------|---------|-----------------|
|                      |  | % of<br>Revenue |         | % of<br>Revenue |  | % of<br>Revenue |         | % of<br>Revenue |
| Revenue:             |  |                 |         |                 |  |                 |         |                 |
| Medical device       | \$2,024                                    | 72%             | \$1,690 | 64%             | \$3,763                                  | 70%             | \$3,389 | 65%             |
| Industrial           | 519  | 19%             | 497     | 19%             | 1,040                                    | 19%             | 1,017   | 20%             |
| Dental               | 214  | 8%              | 443     | 17%             | 421                                      | 8%              | 767     | 15%             |
| Government and other | 35   | 1%              | 10      | —               | 163                                      | 3%              | 21      | —               |
|                      | \$2,792                                    | 100%            | \$2,640 | 100%            | \$5,387                                  | 100%            | \$5,194 | 100%            |

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

Shipments to our largest customer, accounted for in medical device revenue, increased approximately \$395,000 and \$806,000, respectively, for the three and six months ended December 31, 2014 from their corresponding periods in 2013. Sales to two other large medical device customers decreased by approximately \$79,000 and \$413,000, respectively, for the three and six months ended December 31, 2014 compared to the three and six months ended December 31, 2013. We expect no future revenue from one of these customers, which provided revenue of \$100,000 and \$110,000 for the three and six months ended December 31, 2014.

At December, 2014, we had a backlog of approximately \$7.6 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.

***Cost of Sales and Gross Margin***  
*(in thousands except percentages)*

|                | Three Months Ended<br>December 31,<br>2014 |               | 2013 |               | Six Months Ended<br>December 31,<br>2014 |               | 2013 |               |
|----------------|--|---------------|------|---------------|--|---------------|------|---------------|
|                |  | % of<br>Total |      | % of<br>Total |  | % of<br>Total |      | % of<br>Total |
| Cost of sales: |  |               |      |               |  |               |      |               |

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|   |         |      |         |      |         |      |         |      |
|---|---------|------|---------|------|---------|------|---------|------|
| Product cost                            | \$1,882 | 90 % | \$1,953 | 93 % | \$3,565 | 92 % | \$3,487 | 94 % |
| Under-absorption of manufacturing costs | 15      | 1 %  | 107     | 5 %  | 104     | 3 %  | 162     | 5 %  |
| Inventory and warranty charges          | 199     | 9 %  | 31      | 2 %  | 194     | 5 %  | 51      | 1 %  |
|   | \$2,096 | 100% | \$2,091 | 100% | \$3,863 | 100% | \$3,700 | 100% |

|              | <b>Three Months Ended<br/>December 31,</b> |             | <b>Six Months Ended<br/>December 31,</b> |             | <b>Year over Year<br/>ppt Change</b> |                       |
|--------------|--|-------------|--|-------------|--------------------------------------|-----------------------|
|              | <b>2014</b>                                | <b>2013</b> | <b>2014</b>                              | <b>2013</b> | <b>Three<br/>Months</b>              | <b>Six<br/>Months</b> |
| Gross margin | 25%  | 21%         | 28%                                      | 29%         | 4                                    | (1)                   |

Cost of sales for the three months ended December 31, 2014 is comparable to the corresponding period of the prior fiscal year, although there are significant changes in component costs within cost of sales. Under-absorption of manufacturing costs decreased by \$92,000 for the three months ended December 31, 2014 compared to the corresponding period of the prior year due primarily to increased manufacturing volume in 2014. Also included in product cost for the quarter ended December 31, 2014 was an accrual of \$93,000 for anticipated losses from the

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development services portion of certain contracts, compared to \$196,000 recorded in the corresponding quarter of the prior year. Costs relating to inventory and warranty charges increased by \$168,000 for the quarter ended December 31, 2014 compared to the second quarter of the prior fiscal year. The warranty accrual estimate increased due to higher volume of sales of specific products as well as an increase in the estimated cost to repair those products in the current fiscal year versus the prior fiscal year.

Gross profit increased by approximately \$147,000 or 27 percent for the three months ended December 31, 2014 compared to the corresponding period of the prior fiscal year, primarily as a result of the increase in revenue discussed above. Gross margin as a percentage of sales increased by approximately 4 percentage points compared to the corresponding period of the prior year due primarily to the effects of the under-absorption of manufacturing costs and accruals discussed above, partially offset by increases in warranty costs.

Cost of sales for the six months ended December 31, 2014 increased by \$163,000 or 4 percent compared to the corresponding period of the prior fiscal year, primarily due the increase in inventory and warranty charges for the same period, the reasons for which are discussed above. Additionally, product cost for the six months ended December 31, 2014 and 2013 includes an accrual of approximately \$141,000 and \$231,000, respectively, relating to estimated contract losses for certain engineering development projects that are on-going, for which we have not yet recognized revenue. Finally, cost of sales reflects a \$58,000 decrease in under-absorbed manufacturing costs due to increased manufacturing volumes.

Gross profit remained relatively flat for the six months ended December 31, 2014 compared to the corresponding period of the prior year, primarily as a result of the increases in revenue and cost of sales discussed above. Gross margin declined by approximately 1 percentage point, compared to the corresponding period of the prior year, due to the effects of the higher inventory and warranty charges discussed above.

## Operating Expenses

### *Operating Costs and Expenses* (in thousands except % change)

|                     | Three Months Ended<br>December 31, |                 | Six Months Ended<br>December 31, |                 | Year over<br>% Change |                 | Three Months<br>M | N  |     |    |
|---------------------|------------------------------------|-----------------|----------------------------------|-----------------|-----------------------|-----------------|-------------------|----|-----|----|
|                     | 2014                               | 2013            | 2014                             | 2013            | Three Months          | Months          |                   |    |     |    |
|                     |                                    | % of<br>Revenue |                                  | % of<br>Revenue |                       | % of<br>Revenue |                   |    |     |    |
| Operating expenses: |                                    |                 |                                  |                 |                       |                 |                   |    |     |    |
| Selling expenses    | \$ 186                             | 7%              | \$ 139                           | 5%              | \$ 328                | 6%              | \$ 231            | 5% | 34% | 4% |

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|                                     |         |     |       |     |         |     |         |     |     |    |
|-------------------------------------|---------|-----|-------|-----|---------|-----|---------|-----|-----|----|
| General and administrative expenses | 459     | 16% | 422   | 16% | 950     | 18% | 878     | 17% | 9%  | 8  |
| Research and development costs      | 444     | 16% | 364   | 14% | 829     | 15% | 740     | 14% | 22% | 12 |
|                                     | \$1,089 | 39% | \$925 | 35% | \$2,107 | 39% | \$1,849 | 36% | 18% | 14 |

Selling expenses consist of salaries and other personnel-related expenses for our business development department as well as trade show attendance, advertising and marketing expenses, and travel and related costs incurred in generating and maintaining our customer relationships. Also, beginning in the second quarter of the current fiscal year, we launched our engineering services division (“ESD”) to recruit and place contract personnel in engineering, manufacturing and other technical consulting services. This division includes a team of sales and recruiting staff. Selling expenses for the three and six months ended December 31, 2014 increased \$47,000, or 34 percent, and \$97,000, or 42 percent, respectively, compared to the corresponding periods of fiscal 2013. Approximately \$80,000 of the increase is primarily attributable the launch of ESD for both the three and six months ended December 31, 2014, respectively, compared to the three and six months ended December 31, 2013. Offsetting the increases in selling expenses from ESD during the three month period ended December 31, 2014 compared to the three month period ended December 31, 2013, were declines of \$24,000 and \$11,000 in payroll and

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related costs, and consulting fees, respectively, associated with our sales and marketing department focused primarily on medical, dental and industrial revenue generating activities.

General and administrative expenses (“G&A”) consists of salaries and other personnel-related expenses of our accounting, finance and human resource personnel, professional fees, directors’ fees, and other costs and expenses attributable to being a public company. G&A increased by \$37,000 and \$72,000, for the three and six months ended December 31, 2014, respectively, when compared to the corresponding periods of the prior fiscal year. These increases primarily relate to increased legal fees relating to services provided in conjunction with acquisitions and other non-routine transactions.

Research and development costs generally consist of salaries, employer paid benefits, and other personnel related costs of our engineering and support personnel, as well as allocated facility and information technology costs, professional and consulting fees, patent-related fees, lab costs, materials, and travel and related costs incurred in the development and support of our products. Research and development costs for the three and six months ended December 31, 2014 increased by \$80,000, or 22 percent, and by \$89,000, or 12 percent, respectively, compared to the corresponding period of the prior fiscal year due primarily to the launch of an engineering battery development project to enable us to manufacture batteries for our powered surgical devices in-house as well as additional consulting expenses.

#### *Interest Expense*

Interest expense consists primarily of interest expense related to capital lease obligations for leased office equipment, and did not materially differ for the three and six months ended December 31, 2014 when compared to corresponding periods in 2013.

#### *Realized Gain on Sale of Investments*

During the three and six months ended December 31, 2014, we sold certain of our investments in marketable equity securities of publicly held companies and recorded realized gains of \$59,000. We did not sell any investments during the corresponding periods of the prior fiscal year.

#### *Income Tax Benefit*

The effective tax rates for the three and six months ended December 31, 2014 and 2013 are lower than statutory tax rates due to our inability to fully recognize the benefits of federal and state loss carryforwards prior to their utilization. (See Note 8 of Notes to Condensed Consolidated Financial Statements contained elsewhere in this report.)

## Liquidity and Capital Resources

Cash and cash equivalents at December 31, 2014 decreased \$1.2 million to \$2.0 million as compared to \$3.2 million at June 30, 2014. The following table includes a summary of our condensed consolidated statements of cash flows contained elsewhere in this report.

|                             | As of and For the<br>Six Months<br>Ended December<br>31,<br>2014      2013<br>(in thousands) |          |
|-----------------------------|--|----------|
| Cash provided by (used in): |  |          |
| Operating activities        | \$263  | \$(640 ) |
| Investing activities        | \$(1,377)  | \$516    |
| Financing activities        | \$(101 )   | \$(2 )   |
| Cash and Working Capital:   |  |          |
| Cash and cash equivalents   | \$1,973  | \$1,544  |
| Working Capital             | \$6,273  | \$5,558  |

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## Operating Activities

Cash provided by operating activities was \$263,000 for the six months ended December 31, 2014 primarily due to collections of accounts receivable in the amount of \$673,000, an increase in accounts payable, accrued expenses and deferred rent of \$326,000, mostly due to increased accruals for warranty and an increase in payables due to inventory purchases and non-cash depreciation and amortization expense of \$259,000. Additionally, we had an increase in deferred revenue of \$269,000 for the six months ended December 31, 2014 relating to contractual payments made to us by customers in advance of our ability to recognize such payments as revenue. Uses of cash offsetting the amounts above include our net loss of \$362,000, an increase of \$342,000 in unbilled receivables related to the development phase of certain contracts that have not yet reached the revenue recognition stage under the completed contract method of accounting, an increase of \$275,000 in inventory purchases and an increase of \$103,000 in prepaid expenses, mostly related to corporate insurances. Additionally, we recorded non-cash deferred income tax benefits of \$77,000 and had a decrease in income taxes payable in the amount of \$53,000.

Net cash used in operating activities during the six months ended December 31, 2013 amounted to \$640,000. Uses of cash arose from an increase in accounts receivable of \$259,000, primarily due to the resumption, in December 2013, of shipments to our largest customer, the payments for which were not received until January 2014 in conformity with our customary credit terms, an increase of \$367,000 in unbilled receivables related to the development phase of certain contracts that had not yet reached the billable stage under the completed contract method of accounting, and a decrease in accounts payable, accrued liabilities and deferred rent, aggregating \$422,000, due primarily to payments made during the six months ended December 31, 2013 for inventory purchased during the quarter ended June 30, 2013. Sources of cash arose from a reduction in inventories of \$282,000, reflecting primarily the resumption of shipments to our largest customer, and a \$106,000 increase in deferred revenue related to contractual payments made to us by customers in advance of our ability to recognize such payments as revenue.

## Investing Activities

During the six months ended December 31, 2014, we invested \$1.2 million in the purchase of notes receivable as further described in Note 6 to the Condensed Consolidated Financial Statements contained elsewhere in this report. We also purchased Huber Precision for \$209,000, made capital expenditures primarily for tooling and manufacturing equipment in the amount of \$209,000 and received \$318,000 in proceeds from the sale of equity securities in conformity with our Surplus Capital Investment Policy described in more detail below. Additionally, we expended \$61,000 in capitalized legal fees and software development costs related to internally developed intellectual property.

Net cash provided by investing activities for the six months ended December 31, 2013 was \$516,000. This increase was due primarily to proceeds of \$900,000 from the sale of land and building we owned in Carson City, Nevada that housed our former Astromec operations, partially offset by additions of \$329,000 we made to our investments in marketable equity securities in conformity with our surplus capital investment policy.

## Financing Activities

During the six months ended December 31, 2014 we spent \$94,000 on the repurchase of company common stock pursuant to the share repurchase program described in more detail below.

Net cash used in financing activities for the six months ended December 31, 2013 was \$2,000 and represented payments on equipment capital leases.

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

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## Financing Facilities

Since September 2012, we have conducted our operations without need of a credit facility. Should we be unable to achieve anticipated cash flows from operations, however, we may be required to seek additional financing, and there is no assurance that such financing will be available on acceptable terms, if at all.

## Surplus Capital Investment Policy

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

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

The composition of the Investment Committee is Messrs. Swenson (Chair), Cabillot and Van Kirk

In June 2013, the Investment Committee approved investments aggregating \$500,000, and approved an additional \$500,000 in July 2013. At December 31, 2014, \$609,000 had been invested in marketable public equity securities, having a market value at December 31, 2014 of \$1.0 million. In addition, at December 31, 2014, \$889,000 had been invested in money market funds.

In September 2013, our Board approved a share repurchase program authorizing the Company to repurchase up to 750,000 shares of our common stock. In accordance with, and as part of, this share repurchase program, our Board approved, on September 23, 2014, the adoption of a prearranged share repurchase plan intended to qualify for the safe harbor under Rule 10b5-1 under the Securities Exchange Act of 1934, as amended (“10b5-1 Plan”). The 10b5-1 Plan became effective on September 24, 2014 and terminates on March 23, 2015, unless terminated sooner in accordance with its terms. Through December 31, 2014, we repurchased 41,538 shares at an aggregate cost of \$94,000, inclusive of fees, under the terms of the 10b5-1 Plan. Repurchases under the 10b5-1 Plan are administered through an independent broker.

## Rights Offering

On December 17, 2013, we publicly announced plans to complete a rights offering to existing holders of our Common Stock, and we commenced the rights offering on March 24, 2014, pursuant to a registration statement on Form S-3 filed with the SEC. The rights offering was made through the distribution to our existing shareholders as of March 20, 2014 of non-transferable subscription rights to purchase their pro rata portion of newly issued shares of our Common Stock (the “Subscription Privilege”) at a price of \$1.90 per share (the “Subscription Price”). The subscription period for exercise of the rights commenced on March 24, 2014 and expired on April 25, 2014.

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

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

In connection with the rights offering, we entered into a Standby Purchase Agreement with AO Partners, LLC and Farnam Street Capital, Inc. (each a beneficial shareholder of our common stock; each a “Standby Purchaser” and collectively the “Standby Purchasers”) pursuant to which the Standby Purchasers agreed to purchase,

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at the Subscription Price, any and all shares of Common Stock not subscribed for by shareholders in connection with the rights offering, subject to reduction by us as described below. Messrs. Swenson and Cabillot have the power to direct the affairs of AO Partners, LLC and Farnam Street Capital, respectively. No fees or other consideration were paid by us to the Standby Purchasers in exchange for their commitment to purchase any and all unsubscribed shares of Common Stock following the rights offering.

In the event that the exercise by a shareholder of the Subscription Privilege or the purchase of our common stock under the Standby Purchase Agreement could, in our sole discretion, have potentially resulted in a limitation of our ability to utilize our tax attributes, such as the annual utilization of net operating loss or tax credit carry forwards (see Note 8 of Notes to Condensed Consolidated Financial Statements contained elsewhere in this report), we had the ability to reduce the exercise by such shareholder of the Subscription Privilege or the amount purchased under the Standby Purchase Agreement to such number of shares of our Common Stock as we determined advisable in order to preserve our ability to utilize such tax attributes. On the basis of the Company's analysis of tax attributes, the Company did not reduce the subscriptions of any shareholder in the rights offering, but did reduce to zero the number of shares the Standby Purchasers could have otherwise purchased pursuant to the Standby Purchase Agreement. As a result, no shares were issued to AO Partners, LLC or Farnam Street Capital, Inc. pursuant to the Standby Purchase Agreement.

The proceeds from the rights offering have been used to invest in the notes receivable more fully described in Note 6 to the Condensed Consolidated Financial Statements contained elsewhere in this report. Additionally as described in Note 2 to the Condensed Consolidated Financial Statements contained elsewhere in this report, we acquired Huber for an aggregate purchase price of approximately \$209,000.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

### ITEM 4. CONTROLS AND PROCEDURES

#### Evaluation of Disclosure Controls and Procedures

Our Chief Executive Officer and Chief Financial Officer (the principal executive officer and principal financial officer, respectively) conducted an evaluation of the design and operation of our "disclosure controls and procedures" (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended ("Exchange Act")). The term "disclosure controls and procedures," as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange

Act means controls and other procedures of a company that are designed to ensure that information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures also include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate, to allow timely decisions regarding required disclosure.

In accordance with SEC rules, an evaluation was performed under the supervision and with the participation of our Principal Executive Officer and Principal Financial Officer of the effectiveness, as of December 31, 2014, of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act). "Internal control over financial reporting" includes those policies and procedures that:

(1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;

provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial  
(2) statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and

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- (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements.

Based on that evaluation as of December 31, 2014, our Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures are effective.

#### Internal Control over Financial Reporting

During the three months ended December 31, 2014, there were no changes in our internal controls over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act) that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

#### Inherent Limitations on the Effectiveness of Controls

In designing and evaluating our disclosure controls and procedures, our management recognized that any system of controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, as ours are designed to do, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risks that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

## PART II — OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

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

## ITEM 1A. RISK FACTORS

Our business, future financial condition and results of operations are subject to a number of factors, risks and uncertainties, which are disclosed in Item 1A, entitled “Risk Factors” in Part I of our Annual Report on Form 10-K for our fiscal year ended June 30, 2014 as well as any amendments thereto or additions and changes thereto contained in this quarterly report on Form 10-Q for the quarter ended December 31, 2014. Additional information regarding some of those risks and uncertainties is contained in the notes to the condensed consolidated financial statements included elsewhere in this report and in Item 2, entitled “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in Part I of this report. The risks and uncertainties disclosed in our Form 10-K, our quarterly reports on Form 10-Q and other reports filed with the are not necessarily all of the risks and uncertainties that may affect our business, financial condition and results of operations in the future.

There have been no material changes to the risk factors as disclosed in our annual report on Form 10-K for the fiscal year ended June 30, 2014, except as provided in any amendments thereto and those set forth below.

***We have invested \$1.2 million in promissory notes secured by real property and business assets of a company located in Ramsey, Minnesota. These promissory notes are subject to complex accounting requirements and represent investments unrelated to our core business operations, which could adversely affect our business, financial condition and results of operations.***

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We have acquired \$1.2 million in promissory notes during the second quarter of fiscal 2015 which are subject to complex impairment loss analysis. Any such impairment loss could adversely impact our financial condition and results of operations. In addition, any loss or damage to the collateral securing the promissory notes could materially adversely affect the value of the notes and our ability to realize value from the collateral.

***We may not be able to successfully integrate our recent business acquisitions, which could adversely affect our business, financial condition, and results of operations.***

We have acquired, and may acquire in the future, businesses, products, and technologies that complement or expand our current operations. Acquisitions could require significant capital investments and require us to integrate with companies that have different cultures, management teams, and business infrastructure. Depending on the size and complexity of an acquisition, our successful integration of the acquisition could depend on several factors, including:

- Difficulties in assimilating and integrating the operations, products, and workforce of an acquired business;
- The retention of key employees;
- Management of facilities and employees in separate geographic areas;
- The integration or coordination of different research and development and product manufacturing facilities;
- Successfully converting information and accounting systems, and
- Diversion of resources and management attention from our other operations.

If market conditions or other factors require us to change our strategic direction, we may fail to realize the expected value from one or more of our acquisitions. Our failure to successfully integrate our acquisitions or realize the expected value from past or future acquisitions could harm our business, financial condition, and results of operations.

***Recent changes in our management may lead to changes in our internal control over financial reporting.***

In January 2015, our President, Chief Executive Officer and Chief Financial Officer resigned. Our board of directors appointed Richard Van Kirk to serve President and Chief Executive Officer and Alisha Charlton to serve as Chief Financial Officer. The Company is currently evaluating the impact, if any, of these changes in senior management will have on the Company's internal control over financial reporting.

## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Repurchases by the Company of its common stock during the quarter ended December 31, 2014 were as follows:

| Period                                   | Total<br>Number of<br>Shares<br>Purchased | Average<br>Price<br>Paid per<br>Share | Total<br>Number of<br>Shares<br>Purchased<br>as Part of<br>Publicly<br>Announced<br>Plans or<br>Programs | Maximum<br>Number of<br>Shares that<br>May Yet<br>Be<br>Purchased<br>Under the<br>Plans or<br>Programs |
|--|---|---------------------------------------|--|--|
| October 1, 2014 to<br>October 31, 2014   | 33,688                                    | 2.22                                  | —  | 708,647  |
| November 1, 2014 to<br>November 30, 2014 | 185                                       | 2.19                                  | —  | 708,462  |
| December 1, 2014 to<br>December 31, 2014 | —   | —                                     | —  | 708,462  |

All repurchases were made pursuant to the Company's previously announced repurchase program. For information concerning the Company's repurchase program, please see the discussion under the caption "Share Repurchase Program" in Note 9 to the condensed consolidated financial statements included elsewhere in this report.

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ITEM 6. EXHIBITS

| Exhibit | Description  |
|---------|--|
| 10.1    | Asset Purchase Agreement dated December 8, 2014 by and between Pro-Dex, Inc., Fineline Molds and the shareholders of Fineline Molds (incorporated by reference to Exhibit 10.1 to the Form 8-K filed by the Registrant on December 11, 2014)                             |
| 10.2    | Loan Purchase and Sale Agreement, dated November 21, 2014, among the Bank, Pro-Dex Sunfish Lake, LLC, Heron Enterprises, LLC and Scott Robertson (incorporated by reference to Exhibit 10.1 to the Form 8-K filed by the Registrant on November 28, 2014)                |
| 10.3    | Promissory Notes, as of various dates, issued by Riverside Manufacturing, Inc. in favor of the Bank (incorporated by reference to Exhibit 10.2 to the Form 8-K filed by the Registrant on November 28, 2014)   |
| 10.4    | Promissory Notes, as of various dates, issued by Sheldon A. Mayer, LLC in favor of the Bank (incorporated by reference to Exhibit 10.3 to the Form 8-K filed by the Registrant on November 28, 2014)   |
| 10.5    | Debt Purchase Agreement, dated November 21, 2014, Pro-Dex Sunfish Lake, LLC, Heron Enterprises, LLC, and Scott C. Robertson (incorporated by reference to Exhibit 10.4 to the Form 8-K filed by the Registrant on November 28, 2014)                                     |
| 10.6    | Promissory Note, dated September 20, 2013, issued by Riverside Manufacturing, Inc. in favor of Heron Enterprises, LLC (incorporated by reference to Exhibit 10.5 to the Form 8-K filed by the Registrant on November 28, 2014)   |
| 10.7    | Combination Amended and Restated Convertible Promissory Note, dated August 15, 2012, issued by Riverside Manufacturing, Inc. in favor of Heron Enterprises, LLC (incorporated by reference to Exhibit 10.6 to the Form 8-K filed by the Registrant on November 28, 2014) |
| 10.8    | Employment Agreement, dated November 21, 2014, between Pro-Dex Riverside, LLC and Scott C. Robertson (incorporated by reference to Exhibit 10.7 to the Form 8-K filed by the Registrant on November 28, 2014)  |
| 31.1    | Certification of Principal Executive Officer Pursuant to 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 Principal Financial Officer Pursuant to 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

32.1 Certification of Principal Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32.2 Certification of Principal Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

101.INS\* XBRL Instance Document

101.SCH\* XBRL Taxonomy Extension Schema Document

101.CAL\* XBRL Taxonomy Extension Calculation Linkbase Document

101.DEF\* XBRL Taxonomy Extension Definition

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101.LAB\*

XBRL Taxonomy Extension Label Linkbase Document

101.PRE\*

XBRL Taxonomy Extension Presentation Linkbase Document

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\*The XBRL-related information in Exhibit 101 to this Quarterly Report on Form 10-Q shall not be deemed “filed” for the purposes of Section 18 of the Securities Exchange Act of 1934 or otherwise subject to the liability of that section, nor shall it be deemed incorporated by reference in any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934.

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SIGNATURES

Pursuant to the requirements 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.

Date: February 10, 2015

/s/ Richard L. Van Kirk  
Richard L. Van Kirk  
Chief Executive Officer  
(Principal Executive Officer)

Date: February 10, 2015

/s/ Alisha K. Charlton  
Alisha K. Charlton  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

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EXHIBIT INDEX

| Exhibit | Description  |
|---------|--|
| 10.1    | Asset Purchase Agreement dated December 8, 2014 by and between Pro-Dex, Inc., Fineline Molds and the shareholders of Fineline Molds (incorporated by reference to Exhibit 10.1 to the Form 8-K filed by the Registrant on December 11, 2014)                             |
| 10.2    | Loan Purchase and Sale Agreement, dated November 21, 2014, among the Bank, Pro-Dex Sunfish Lake, LLC, Heron Enterprises, LLC and Scott Robertson (incorporated by reference to Exhibit 10.1 to the Form 8-K filed by the Registrant on November 28, 2014)                |
| 10.3    | Promissory Notes, as of various dates, issued by Riverside Manufacturing, Inc. in favor of the Bank (incorporated by reference to Exhibit 10.2 to the Form 8-K filed by the Registrant on November 28, 2014)   |
| 10.4    | Promissory Notes, as of various dates, issued by Sheldon A. Mayer, LLC in favor of the Bank (incorporated by reference to Exhibit 10.3 to the Form 8-K filed by the Registrant on November 28, 2014)   |
| 10.5    | Debt Purchase Agreement, dated November 21, 2014, Pro-Dex Sunfish Lake, LLC, Heron Enterprises, LLC, and Scott C. Robertson (incorporated by reference to Exhibit 10.4 to the Form 8-K filed by the Registrant on November 28, 2014)                                     |
| 10.6    | Promissory Note, dated September 20, 2013, issued by Riverside Manufacturing, Inc. in favor of Heron Enterprises, LLC (incorporated by reference to Exhibit 10.5 to the Form 8-K filed by the Registrant on November 28, 2014)   |
| 10.7    | Combination Amended and Restated Convertible Promissory Note, dated August 15, 2012, issued by Riverside Manufacturing, Inc. in favor of Heron Enterprises, LLC (incorporated by reference to Exhibit 10.6 to the Form 8-K filed by the Registrant on November 28, 2014) |
| 10.8    | Employment Agreement, dated November 21, 2014, between Pro-Dex Riverside, LLC and Scott C. Robertson (incorporated by reference to Exhibit 10.7 to the Form 8-K filed by the Registrant on November 28, 2014)  |
| 31.1    | Certification of Principal Executive Officer Pursuant to 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   |

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31.2 Certification of Principal Financial Officer Pursuant to 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

32.1 Certification of Principal Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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XBRL Taxonomy Extension Schema Document

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XBRL Taxonomy Extension Calculation Linkbase Document

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XBRL Taxonomy Extension Definition

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101.LAB\* XBRL Taxonomy Extension Label Linkbase Document

101.PRE\* XBRL Taxonomy Extension Presentation Linkbase Document

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\*The XBRL-related information in Exhibit 101 to this Quarterly Report on Form 10-Q shall not be deemed “filed” for the purposes of Section 18 of the Securities Exchange Act of 1934 or otherwise subject to the liability of that section, nor shall it be deemed incorporated by reference in any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934.

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