

PRO DEX INC
Form 10-Q
May 12, 2016

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

MARCH 31, 2016

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 84-1261240
(State or other jurisdiction (I.R.S. Employer
of incorporation or organization) 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 any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

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Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

Indicate the number of shares outstanding of each of the Registrant's classes of Common Stock outstanding as of the latest practicable date: 4,146,449 shares of Common Stock, no par value, as of May 4, 2016.

PRO-DEX, INC. AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-Q

FOR THE THREE AND NINE MONTHS ENDED MARCH 31, 2016

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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)**

	March 31, 2016	June 30, 2015
ASSETS		
Current Assets:		
Cash and cash equivalents	\$1,452	\$697
Accounts receivable, net of allowance for doubtful accounts of \$18 and \$36, respectively	2,169	2,326
Due from factor	1,581	—
Unbilled receivables	123	853
Other current receivables	113	28
Inventory	4,118	4,310
Prepaid expenses	129	124
Deferred income taxes	—	70
Total current assets	9,685	8,408
Equipment and leasehold improvements, net	1,198	1,470
Investment in Ramsey property and related notes receivable	—	1,652
Goodwill	112	353
Intangibles	442	547
Other assets	80	86
Total assets	\$11,517	\$12,516
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	\$1,132	\$1,867
Accrued expenses	892	1,202
Deferred revenue	117	594
Income taxes payable	3	—
Note payable	24	24
Capital lease obligations	—	7
Total current liabilities	2,168	3,694

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Deferred income taxes	—	70
Deferred rent	157	204
Note payable, net of current portion	52	70
Total non-current liabilities	209	344
Total liabilities	2,377	4,038
Shareholders' equity:		
Common shares; no par value; 50,000,000 shares authorized; 4,152,139 and 4,139,579 shares issued and outstanding at March 31, 2016 and June 30, 2015, respectively	18,440	18,411
Accumulated deficit	(9,300)	(9,933)
Total shareholders' equity	9,140	8,478
Total liabilities and shareholders' equity	\$11,517	\$12,516

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

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

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2016	2015	2016	2015
Net sales	\$5,337	\$3,922	\$14,873	\$9,310
Cost of sales	3,977	2,877	10,916	6,741
Gross profit	1,360	1,045	3,957	2,569
Operating expenses:				
Selling expenses	195	363	665	691
General and administrative expenses	420	592	1,407	1,542
Impairment of goodwill and long-lived assets	245	—	245	—
Research and development costs	450	480	1,313	1,309
Total operating expenses	1,310	1,435	3,630	3,542
Operating income (loss)	50	(390)	327	(973)
Interest expense	(10)	(1)	(36)	(4)
Interest income	—	1	—	6
Gain from sale of Investment in Ramsey Property	340	—	340	—
Gain from disposal of equipment	4	1	18	1
Realized gain on sale of investments	—	395	—	455
Income (loss) from continuing operations before income taxes	384	6	649	(515)
Income tax (expense) benefit	(16)	(98)	(16)	40
Income (loss) from continuing operations	368	(92)	633	(475)
Income from discontinued operations, net of income taxes	—	16	—	37
Net income (loss)	\$368	\$(76)	\$633	\$(438)
Basic and diluted net income (loss) per share:				
Income (loss) from continuing operations	\$0.09	\$(0.02)	\$0.15	\$(0.11)
Income from discontinued operations	—	—	—	0.01
Net income (loss)	\$0.09	\$(0.02)	\$0.15	\$(0.10)
Weighted average common shares outstanding:				
Basic	4,151	4,158	4,145	4,179
Diluted	4,195	4,158	4,169	4,179
Common shares outstanding	4,152	4,140	4,152	4,140

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

PRO-DEX, INC. AND SUBSIDIARIES**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)****(In thousands)**

	Nine Months Ended March 31, 2016 2015	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	\$633	\$(438)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	481	398
Gain on sale of investments	—	(455)
Gain on sale of investment in Ramsey	(340)	—
Gain on disposal of equipment	(18)	(1)
Impairment of goodwill and long-lived assets	245	—
Share-based compensation	4	14
Deferred income tax benefit	—	5
Bad debt expense (recovery)	(18)	1
Changes in operating assets and liabilities:		
Accounts receivable, due from factor and other current receivables	(1,382)	(313)
Unbilled receivables	730	(324)
Inventory	192	(839)
Prepaid expenses and other assets	—	(83)
Accounts payable, accrued expenses and deferred rent	(1,092)	1,352
Deferred revenue	(477)	298
Income taxes payable	3	(53)
Net cash used in operating activities	(1,039)	(438)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of investments	—	(12)
Purchases of equipment and leasehold improvements	(106)	(242)
Business acquisitions	—	(865)
Purchase of notes receivable	—	(1,236)
Investment in Ramsey property and related notes receivable	(87)	—
Proceeds from sale of investment in Ramsey	1,970	—
Proceeds from sale of equipment	18	1
Proceeds from sale of investments	—	1,324
Increase in intangibles	(1)	(50)
Net cash provided by (used in) investing activities	1,794	(1,080)

CASH FLOWS FROM FINANCING ACTIVITIES:

Repurchase of common stock	(2)	(154)
Proceeds from exercise of stock options and ESPP contributions	27	—
Repurchase of stock options	—	(32)
Borrowings from Summit loan	2,050	—
Repayments on Summit loan	(2,050)	—
Payments made for common stock rights offering	—	(3)
Proceeds from note payable	500	—
Principal payments on notes payable and capital lease	(525)	(6)
Net cash used in financing activities	—	(195)
Net increase (decrease) in cash and cash equivalents	755	(1,713)
Cash and cash equivalents, beginning of period	697	3,188
Cash and cash equivalents, end of period	\$1,452	\$1,475

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

PRO-DEX, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS - CONTINUED

(Unaudited)

(In thousands)

	Nine Months Ended March 31, 2016 2015	
Supplemental disclosures of cash flow information:		
Noncash investing and financing activities:		
Promissory note issued in conjunction with a business acquisition	\$—	\$100
Cash paid during the period for:		
Interest	\$36	\$4
Income taxes, net of refunds	\$11	\$9

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

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, 2015. 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, 2015.

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. In July 2015, the FASB deferred the effective date to fiscal years beginning after December 15, 2018 and early adoption of the standard is permitted, but not before the original effective date of December 15, 2017. This update permits the use of either the retrospective or cumulative effect transition method. The Company is evaluating the effect this guidance will have on the consolidated financial statements and related disclosures.

In August 2014, the FASB issued ASU 2014-15, “Presentation of Financial Statements—Going Concern” (Subtopic 205-40). This guidance defines management’s responsibility to evaluate whether there is substantial doubt about an organization’s ability to continue as a going concern and to provide related footnote disclosures. Under the guidance, management is required to evaluate, for each annual and interim reporting period, whether it is probable that the entity will not be able to meet its obligations as they become due within one year after the date that the financial statements are issued or are available to be issued. When management identifies substantial doubt about the entity’s ability to continue as a going concern, additional disclosures are required. This guidance will be effective for annual reporting periods beginning after December 15, 2016. The Company does not believe that the adoption of this guidance will have a material impact on our consolidated financial statements and related disclosures.

In February 2015, the FASB issued ASU 2015-02, "Consolidation". This guidance amends existing consolidation guidance in which a reporting entity might be required to consolidate another legal entity in situations in which the reporting entity's contractual rights do not give it the ability to act primarily on its own behalf, the reporting entity does not hold a majority of the legal entity's voting rights, or the reporting entity is not exposed to a majority of the legal entity's economic benefits or obligations. The guidance:

- modifies the evaluations of whether limited partnerships and similar legal entities are variable interest entities or voting interest entities;
- eliminates the presumption that a general partner should consolidate a limited partner;
- affects the consolidation analysis of reporting entities that are involved with variable interest entities, particularly those that have fee arrangements and related party relationships; and
- provides a scope exception from consolidation guidance for reporting entities with interests in certain investment funds.

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

The guidance is effective for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2015. The Company does not expect the adoption of this guidance to have a material impact on the Company's consolidated results of operations, financial position or cash flows.

In April 2015, the FASB issued ASU 2015-03, "Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs" to simplify the presentation of debt issuance costs. The amendments in this accounting standard update require debt issuance costs be presented on the balance sheet as a direct reduction from the carrying amount of the related debt liability. The amendments in this accounting standard update are to be applied retrospectively and are effective for interim and annual reporting periods beginning after December 15, 2015. We do not expect the adoption of this accounting standard update to have a material impact on our balance sheet.

In November 2015, the FASB issued ASU 2015-17, "Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes" which requires all deferred tax assets and liabilities, as well as any related valuation allowance, to be classified as non-current on the balance sheet. The guidance is effective for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years and earlier adoption is permitted. We have elected early adoption on a prospective basis and have netted \$45,000 of current deferred income tax assets against \$45,000 of long term deferred income tax liabilities as of March 31, 2016 in the accompanying condensed consolidated balance sheet.

In February 2016, the FASB issued ASU 2016-02, (Topic 842) "Leases". The objective of this update is to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. This ASU is effective for fiscal years beginning after December 15, 2018, including interim periods within those annual periods and is to be applied utilizing a modified retrospective approach. The Company is currently evaluating the new guidance to determine the impact it may have on its consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, Compensation-Stock Compensation (Topic 718) "Improvements to Employee Share-Based Payment Accounting". This update simplifies the accounting for employee share-based payment transactions, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. This ASU is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. Early adoption is permitted. The Company is currently evaluating the new guidance to determine the impact it may have on its consolidated financial statements.

NOTE 2. BUSINESS ACQUISITIONS

During the nine months ended March 31, 2015, we completed two acquisitions. On December 1, 2014, we completed the acquisition of Huber Precision (“Huber”), a manufacturer of machined parts, primarily for the oil and electronics industry. The aggregate purchase price paid was \$209,000. On February 1, 2015, we completed the acquisition of Fineline Molds (“Fineline”), a manufacturer of plastic injection molds for a variety of industries. The aggregate purchase price was \$757,000, of which \$657,000 was paid in cash at closing and \$100,000 is to be paid by the Company under the terms of a four-year promissory note issued to Fineline at closing, which bears interest at 4% per annum and requires sixteen equal quarterly payments of principal and accrued interest in the amount on \$6,794 each. The note is secured by all of the assets acquired by us from Fineline and is subordinate to the security interest created by the Summit Loan (as defined and described in Note 5).

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

The following summarizes the consideration paid and the estimated fair values of the assets acquired for each acquisition as of the respective acquisition date (in thousands):

	Huber Purchase Price Allocation	Fineline Purchase Price Allocation
Consideration:		
Cash	\$ 209	\$ 657
Promissory note payable to seller	—	100
Total consideration	\$ 209	\$ 757
Fair value of assets acquired:		
Inventory	\$ 5	\$ —
Fixed Assets	37	149
Covenant not to compete	30	22
Trade name	—	54
Customer list and backlog	137	179
Net assets acquired	\$ 209	\$ 404
Goodwill	\$ —	\$ 353

The acquisitions were completed to support expansion of our business and broaden the Company's customer base. We have accounted for these acquisitions as business combinations using the acquisition method of accounting. 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 either the Huber or Fineline acquisitions. The results of operations related to the businesses acquired have been included in the Company's consolidated statements of operations since the date of each respective acquisition. Pro forma historical results of operations related to both acquisitions during the period prior to the acquisition date have not been presented because they are not material to our consolidated statements of operations.

The fair value determination of assets recorded are those of management. The fair value determination of the customer list and backlog was based on the excess of earnings method which is based on the prospective net cash flows of the existing customers. The fair value determination of the trade name was based upon a relief from royalty approach which assesses the royalty savings an entity realizes since it owns the asset and isn't required to pay a third party license for its use. The fair value determination of the covenants not to compete was based upon a discounted cash flow model.

NOTE 3: GOODWILL AND INDEFINITE-LIVED ASSETS

Goodwill represents the excess of the purchase price over the fair value of identifiable net assets of acquired businesses. Indefinite-lived intangibles are intangible assets whose useful lives are indefinite in that their lives extend beyond the foreseeable horizon – that is there is no foreseeable limit on the period of time over which they are expected to contribute to the cash flows of the reporting entity. The Company accounts for these items in accordance with Accounting Standards Codification (“ASC”) 350 Intangibles – Goodwill and Other, which requires that impairment testing for goodwill is performed at least annually at the reporting unit level. A reporting unit is an operating segment or one level below an operating segment (also known as a component). We perform our annual impairment test as of January 31st of each year. Goodwill is also tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying value.

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

The following table presents the changes in the carrying amount of the Fineline goodwill and trade name (in thousands):

	Goodwill	Trade name
Balance at July 1, 2015	\$ 353	\$ 54
Impairment charge	(241)	(4)
Balance at March 1, 2016	\$ 112	\$ 50

The impairment test for goodwill uses a two-step approach. Step one compares the fair value of the reporting unit to its carrying value including goodwill. If the carrying value exceeds the fair value, there is a potential impairment and step two must be performed. Step two compares the carrying value of the reporting unit's goodwill to its implied value (i.e., the fair value of the reporting unit less the fair value of the unit's assets and liabilities, including identifiable intangible assets). If the carrying value of goodwill exceeds its implied value, the excess is recorded as an impairment.

Under Step 1 of the impairment test the Company determined that the carrying value of the reporting unit including goodwill exceeded the fair value, requiring us to perform Step 2 of the goodwill impairment test to measure the amount of impairment loss, if any.

The Company then performed Step 2 of the impairment test, and determined the implied value of Fineline goodwill was \$112,000, which was less than its carrying value and, as a result, the Company recognized a non-cash, pre-tax charge of \$241,000 during the three and nine months ended March 31, 2016. Additionally, our analysis indicated that the estimated fair value of the trade name acquired was \$50,000 and therefore we recognized an impairment charge of \$4,000 during the three and nine months ended March 31, 2016. These impairment charges are included under the caption "Impairment of goodwill and long-lived assets" in our consolidated statements of operations. There were no impairment charges recognized during the three and nine months ended March 31, 2015.

The valuation methods utilized to value the long-lived assets and the goodwill discussed above are based on the amount and timing of expected future cash flows and growth rates and include a determination of an appropriate discount rate. The cash flows utilized in the discounted cash flow analyses were based on financial forecasts developed internally by management. Estimating future cash flows requires significant judgment and projections may vary from the cash flows eventually realized. Determining the fair value using a discounted cash flow method

requires significant estimates and assumptions, including market conditions, discount rates, and long-term projections of cash flows. The Company's estimates are based upon historical experience, current market trends, projected future volumes and other information. The Company believes that the estimates and assumptions underlying the valuation methodology are reasonable; however, different estimates and assumptions could result in a different estimate of fair value.

PRO-DEX, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

NOTE 4. 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):

	March 31, 2016	June 30, 2015
Raw materials /purchased components	\$2,031	\$2,025
Work in process	949	1,030
Sub-assemblies /finished components	993	1,095
Finished goods	145	160
Total inventory	\$4,118	\$4,310

Intangibles

Intangibles consist of the following (in thousands):

	March 31, 2016	June 30, 2015
Capitalized software development costs	\$73	\$73
Covenant not to compete	52	52
Trade name	50	54
Customer list and backlog	316	316
Patent-related costs	96	96
Total intangibles	\$587	\$591
Less accumulated amortization	(145)	(44)

Capitalized software development costs relate to internally developed software, which are being amortized over the estimated minimum unit sales of the underlying product which was released during the fourth quarter of fiscal 2015. Both the covenant not to compete and the customer list and backlog relate to assets acquired in conjunction with the business acquisitions more fully described in Note 2 and are being amortized over various periods not to exceed ten years. The trade name relates exclusively to Fineline Molds and has an indefinite life, subject to impairment loss consideration annually, and more frequently if certain conditions exist (see Note 3). Patent-related costs consist of legal fees incurred in connection with patent applications, which we began amortizing in the third quarter of fiscal 2016 upon the related patent issuance, over a period of seven years, the estimated life of the product that is currently utilizing the patented technology.

NOTE 5. DUE FROM FACTOR

On September 9, 2015, we entered a Loan and Security Agreement (the “Summit Loan”) with Summit Financial Resources LP, (the “Factor”) whereby we can borrow up to \$1.0 million against our eligible receivables, on a revolving basis, as defined in the agreement. Borrowed funds will bear interest at a rate of prime plus 2 percent, and incur an additional administrative fee of 0.7 percent on the monthly average outstanding balance. The Summit Loan has an initial period of 18 months with successive one year renewal options and requires an annual facility fee of \$10,000.

PRO-DEX, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

As of March 31, 2016, the total amount of receivables that have been assigned to the Factor pursuant to the Summit Loan is \$1.6 million and we bear the risk of loss in the event of non-payment by the customers. During the three and nine months ended March 31, 2016, we borrowed \$450,000 and \$2.1 million, on a revolving basis, respectively, under the Summit Loan, which amounts were paid in full by March 31, 2016. Therefore, at March 31, 2016, we had no outstanding borrowings against the Summit Loan.

NOTE 6. 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 March 31, 2016 and June 30, 2015, the warranty reserve amounted to \$410,000 and \$261,000, 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 March 31, 2016 and 2015 was \$49,000 and \$103,000, respectively, and for the nine months ended March 31, 2016 and 2015 was \$226,000 and \$253,000, respectively.

Information regarding the accrual for warranty costs for the three and nine months ended March 31, 2016 and 2015 are as follows (in thousands):

	As of and for the Three Months Ended March 31,	
	2016	2015
Beginning balance	\$367	\$332
Accruals during the period	107	114
Changes in estimates of prior period warranty accruals	(58)	(11)
Warranty amortization	(6)	(42)
Ending balance	\$410	\$393

	As of and for the Nine Months Ended March 31,	
	2016	2015
Beginning balance	\$261	\$237
Accruals during the period	306	263
Changes in estimates of prior period warranty accruals	(80)	(10)
Warranty amortization	(77)	(97)
Ending balance	\$410	\$393

NOTE 7. NET INCOME (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 22,195 and 22,789, respectively, have been excluded from diluted weighted average common shares for the three months and nine months ended March 31, 2015, as the effect would have been anti-dilutive.

PRO-DEX, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

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 Ended March 31, 2016		Nine Months Ended March 31, 2015	
Basic:				
Income (loss) from continuing operations	\$368	\$(92)	\$633	\$(475)
Weighted average shares outstanding	4,151	4,158	4,145	4,179
Basic income (loss) per share from continuing operations	\$0.09	\$(0.02)	\$0.15	\$(0.11)
Income from discontinued operations	\$—	\$16	\$—	\$37
Weighted average shares outstanding	4,151	4,158	4,145	4,179
Basic and diluted earnings per share from discontinued operations	\$0.00	\$0.00	\$0.00	\$0.01
Net income (loss)	\$368	\$(76)	\$633	\$(438)
Weighted average shares outstanding	4,151	4,158	4,145	4,179
Basic and diluted loss per share	\$0.09	\$(0.02)	\$0.15	\$(0.10)
Diluted:				
Income (loss) from continuing operations	\$368	\$(92)	\$633	\$(475)
Weighted average shares outstanding	4,151	4,158	4,145	4,179
Effect of dilutive securities – stock options	44	—	24	—
Weighted average shares used in calculation of diluted earnings per share	4,195	4,158	4,169	4,179
Basic and diluted loss per share from continuing operations	\$0.09	\$(0.02)	\$0.15	\$(0.11)
Income from discontinued operations	\$—	\$16	\$—	\$37
Weighted average shares outstanding	4,195	4,158	4,169	4,179
Diluted earnings per share from discontinued operations	\$0.00	\$0.00	\$0.00	\$0.01
Net income (loss)	\$368	\$(76)	\$633	\$(438)
Weighted average shares outstanding	4,195	4,158	4,169	4,179
Diluted income (loss) per share	\$0.09	\$(0.02)	\$0.15	\$(0.10)

PRO-DEX, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

NOTE 8. INVESTMENT IN RAMSEY PROPERTY AND RELATED NOTES RECEIVABLE

In November 2014, the Company purchased two promissory notes through a Loan Purchase and Sale Agreement in the amount of \$1.2 million. The promissory notes were cross-collateralized and originally 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 were recorded at their purchase price and since the notes remained in default, they were placed on nonaccrual status and therefore, the Company did not collect or recognize any interest income since the date of purchase. Additionally, due to uncertainties relating to future cash flows projected to be received on the notes, no accretable yield was recorded.

During the third quarter of fiscal 2015, we entered into forbearance agreements with Riverside whereby we agreed to forbear from enforcing our rights under the promissory notes until July 31, 2015. Additionally, we entered into a revolving loan agreement, whereby we agreed to advance Riverside from time-to-time up to an aggregate amount of \$200,000 at any time prior to July 31, 2015. During the fourth quarter of fiscal 2015, we amended the revolving loan agreement to provide for advances to Riverside of up to an aggregate amount of \$300,000 under a Revolving Loan Modification Agreement.

Additionally, during the fourth quarter of fiscal 2015, we entered a settlement agreement such that we received the deed to the land and building located in Ramsey, Minnesota (the “Ramsey Property”) which had previously been held as security for the notes receivable. The notes were considered impaired because we did not believe the contractual payments would be collected pursuant to contract terms. Accordingly, the recorded investment was reflected at the lesser of the purchase price or the estimated fair value of the collateral (with appropriate reductions for estimated disposal costs).

On September 22, 2015 we sent Riverside a proposal to accept the collateral in full satisfaction of Riverside’s debt. On October 13, 2015, title to the collateral transferred to the Company by operation of law. Therefore, on October 13, 2015, we took possession of all assets secured by the revolving loan agreement and promissory notes and Riverside

ceased to operate.

During the third quarter ended March 31, 2016 we sold the Ramsey Property for an aggregate purchase price of \$1,653,000, collecting \$1,441,000 upon close of escrow. Additionally, during the second and third quarter of fiscal 2016 we liquidated the machine shop equipment and collected some accounts receivable that served as collateral to the promissory notes in the gross amount of \$529,000. Therefore, during the third quarter ended March 31, 2016 we recorded a gain on the sale of Investment in Ramsey in the amount of \$340,000, which includes a final accrual in the aggregate amount of \$108,000 for \$86,000 to be released from escrow upon completion of voluntary foreclosure proceedings and \$22,000 due from our equipment liquidator. Such amounts have been recorded as other current receivables in our accompanying condensed consolidated balance sheet.

NOTE 9. NOTES PAYABLE AND FINANCING TRANSACTIONS

Fortitude Income Funds

The Company borrowed \$500,000 from Fortitude Income Funds, LLC under a promissory note dated September 8, 2015. The loan bore interest at 12 percent per annum, contained a loan origination fee of \$15,000 plus expenses, and required monthly interest only payments until its original maturity scheduled on March 15, 2016. The loan was secured by a combination mortgage, security agreement and fixture statement covering the Ramsey Property. On February 22, 2016, the loan was repaid in full in conjunction with the sale of the Ramsey Property described above.

PRO-DEX, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

Summit Financial Resources LP

Additionally, as discussed in Note 5, on September 9, 2015 we entered into the Summit Loan, whereby we can borrow up to \$1.0 million against our eligible receivables, on a revolving basis, as defined in the loan agreement. Borrowed funds will bear interest at a rate of prime plus 2 percent, and incur an additional administrative fee of 0.7 percent on the monthly average outstanding balance. The Summit Loan has an initial period of 18 months with successive one year renewal options and requires an annual facility fee of \$10,000. During the three and nine months ended March 31, 2016 we borrowed \$450,000 and \$2.1 million, on a revolving basis, respectively, under the Summit Loan, which amounts were paid in full by March 31, 2016.

Fineline Molds

As discussed in Note 2, in conjunction with our acquisition of the assets of Fineline we issued a promissory note to Fineline in the amount of \$100,000 which bears interest at 4% per annum and requires sixteen equal quarterly payments of principal and accrued interest in the amount of \$6,794. The note is secured by all of the assets acquired by us from Fineline and is subordinate to the security interest created by the Summit Loan. The balance owed on the note as of March 31, 2016 and June 30, 2015 was approximately \$76,000 and \$94,000 respectively.

NOTE 10. 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 \$3.9 million against our deferred tax assets as of March 31, 2016.

As of March 31, 2016, we have accrued \$447,000 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, 2015	\$ 399
Additions based on tax positions related to the current year	29
Additions for tax positions of prior years	19
Balance at March 31, 2016	\$447

We recognize accrued interest and penalties related to unrecognized tax benefits when applicable. As of March 31, 2016, 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, 2013 and later. Our state income tax returns are open to audit under the statute of limitations for the years ended June 30, 2012 and later. We do not anticipate a significant change to the total amount of unrecognized tax benefits within the next 12 months.

PRO-DEX, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

NOTE 11. COMMON STOCK

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 March 22, 2016, the adoption of a second 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” or “Plan”). The current 10b5-1 Plan became effective on March 23, 2016 and through March 31, 2016 we repurchased 536 shares at an aggregate cost of approximately \$2,000. The current 10b5-1 Plan will terminate on September 22, 2016, unless earlier terminated in accordance with its provisions. Our prior 10b5-1 Plan commenced on September 24, 2014 and terminated on March 23, 2015. Through March 23, 2015, we repurchased 69,773 shares at an aggregate cost of \$154,000, inclusive of fees, under the terms of the prior 10b5-1 Plan. Repurchases under both 10b5-1 Plans were administered through an independent broker.

NOTE 12. 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 forfeiture 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 March 31, 2016 and 2015 was \$0 and \$3,000, respectively, and for the nine months ended March 31, 2016 and 2015 was \$2,000 and \$14,000, respectively.

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.

Stock Options

No options were granted during the three or nine months ended March 31, 2016 and 2015. As of March 31, 2016, there was no unrecognized compensation cost under the Stock Option Plans as all outstanding stock options are fully vested.

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

Following is a summary of stock option activity for the nine months ended March 31, 2016 and 2015:

	2016		2015	
	Number of Shares	Weighted- Average Exercise Price	Number of Shares	Weighted- Average Exercise Price
Outstanding at July 1,	106,668	\$ 2.41	165,002	\$ 2.40
Options granted	—	—	—	—
Options exercised	(7,500)	2.14	(48,333)	1.87
Options forfeited	(8,334)	7.65	(10,001)	4.94
Outstanding at end of period	90,834	\$ 1.95	106,668	\$ 2.41
Stock Options Exercisable at March 31,	90,834	\$ 1.95	101,668	\$ 2.44

Following is a summary of information regarding options outstanding and options exercisable at March 31, 2016:

Options Outstanding & Exercisable				
Range of Exercise Prices	Number Outstanding	Weighted-Avg. Remaining Contractual Life	Weighted- Avg. Exercise Price	Aggregate Intrinsic Value
\$0 to 2.50	87,500	5.53	\$1.86	\$171,850
2.5 to 5.00	3,334	1.13	4.38	—
Total	90,834	5.37 years	\$1.95	\$171,850

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 ESPP was approved by our shareholders at the December 3, 2014 Annual Meeting. On 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.

During the first quarter ended September 30, 2015, 1,925 shares were purchased and allocated to employees based upon their contributions at a price of \$2.34 per share, upon the completion of the first offering period. During the third quarter ended March 31, 2016, 3,671 shares were purchased and allocated to employees based upon their contributions at a price of \$2.31 per share, upon the completion of the second offering period.

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

The following is a summary of restricted share activity for the nine months ended March 31, 2016 and 2015:

	2016		2015	
	Number of Shares	Weighted- Average Grant Date Fair Value	Number of Shares	Weighted- Average Grant Date Fair Value
Outstanding at beginning of period	5,000	\$ 1.73	13,333	\$ 1.73
Granted	—	—	—	—
Vested	(5,000)	1.73	(6,667)	1.73
Forfeited	—	—	(1,666)	1.73
Outstanding at end of period	—	\$ —	5,000	\$ 1.73

NOTE 13. MAJOR CUSTOMERS

Information with respect to customers that accounted for sales in excess of 10% of our total sales in either of the three-month and the nine-month periods ended March 31, 2016 and 2015, is as follows (in thousands, except percentages):

Three Months Ended March 31,			
2016		2015	
Amount	Percent	Amount	Percent
of		of	

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	Total			Total		
Total revenue	\$5,337	100	%	\$3,922	100	%

Customer concentration:

Customer 1	\$953	18	%	\$385	10	%
Customer 2	1,142	21	%	1,900	48	%
Customer 3	930	17	%	—	—	
Total	\$3,025	56	%	\$2,285	58	%

Nine Months Ended March 31,
2016

	Percent		Percent	
Amount	of	Amount	of	
	Total	Total	Total	

Total revenue	\$14,873	100	%	\$9,310	100	%
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Customer concentration:

Customer 1	3,375	23	%	410	4	%
Customer 2	2,881	19	%	4,987	54	%
Customer 3	2,158	15	%	—	—	
Total	\$8,414	57	%	\$5,397	58	%

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

Information with respect to accounts receivable from those customers whom comprised more than 10% of our gross accounts receivable at either March 31, 2016 or June 30, 2015, is as follows (in thousands, except percentages):

	March 31, 2016		June 30, 2015	
Total gross accounts receivable, including amounts due from factor	\$3,768	100 %	\$2,362	100 %
Customer concentration:				
Customer 1	\$953	25 %	\$78	3 %
Customer 2	697	18 %	711	30 %
Customer 3	746	20 %	—	—
Customer 4	344	9 %	303	13 %
Customer 5	256	7 %	531	22 %
Total	\$2,996	79 %	\$1,623	68 %

Information with respect to suppliers that accounted for purchases in excess of 10% of our total purchases in either of the three-month and the nine-month periods ended March 31, 2016 and 2015, is as follows (in thousands, except percentages):

	Three Months Ended March 31, 2016		2015	
	Amount of Total	Percent	Amount of Total	Percent
Total purchases	\$3,282	100 %	\$2,907	100 %
Supplier concentration:				
Supplier 1	\$545	17 %	\$—	—
Supplier 2	356	11 %	454	16 %
Total	\$901	28 %	\$454	16 %

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	Nine Months Ended March 31,			
	2016		2015	
		Percent		Percent
	Amount of		Amount of	
	Total		Total	

Total purchases	\$8,662	100 %	\$6,959	100 %
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Supplier concentration:

Supplier 1	\$850	10 %	\$—	—
Supplier 2	1,051	12 %	1,112	16 %
Total	\$1,901	22 %	\$1,112	16 %

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

Information with respect to accounts payable from those suppliers whom comprised more than 10% of our accounts payable at either March 31, 2016 or June 30, 2015, is as follows (in thousands, except percentages):

	March 31, 2016		June 30, 2015	
Total accounts payable	\$ 1,132	100 %	\$ 1,867	100 %
Supplier concentration:				
Supplier 1	\$ 148	13 %	\$ 172	9 %
Supplier 2	160	14 %	679	36 %
Total	\$ 308	27 %	\$ 851	45 %

NOTE 14. SEGMENT INFORMATION

In fiscal 2016, the Company has four reportable segments based on its business activities and organization:

- Pro-Dex located in Irvine, California – providing primarily medical and dental instruments using shared production and assembly machines and workforce. This segment also incorporates Huber Precision as the revenues and assets of Huber Precision are not material to the Company’s total revenues and assets. Additionally, effective November 30, 2015 the former San Carlos office of Huber Precision was closed and all orders shipped since that date are manufactured at the Irvine facility.
- OMS located in Beaverton, Oregon – providing multi-axis motion control applications.
- Fineline located in San Dimas, California. This business was purchased on February 1, 2015 and is a manufacturer of plastic injection molds for a variety of industries.
- Engineering Services Division or (“ESD”). This division was launched in fiscal 2015 to provide permanent placement and contract services in the fields of engineering, manufacturing and quality to diverse businesses.

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

In deciding how to allocate resources and assess performance, the Company's chief executive officer regularly evaluates the sales and operating income of these segments. Operating income is the gross margin of the segment less direct expenses of the segment. Unallocated corporate expenses include our corporate administrative cost center, which primarily includes costs associated with being a public company, as well as general and administrative expenses ("G&A") incurred related to our investment in the Ramsey Property and related notes receivable and is a subset of total general and administrative expenses. Additionally, other costs incurred in our G&A, including salaries and other personnel-related expenses for corporate, accounting, finance and human resource personnel, as well as costs for outsourced information technology services, are not allocated by segment internally and are included in the Pro-Dex segment in the tables below. The following tables summarize segment performance for the three and nine months ended March 31, 2016 and 2015 (in thousands):

	Pro-Dex	OMS	Fineline	ESD	Corporate Unallocated	Total
Three months ended March 31, 2016						
Net Sales	\$ 4,516	\$ 161	\$ 444	\$ 216	\$ —	\$ 5,337
Gross Profit	1,263	47	(8)	58	—	1,360
Operating Income (loss)	608	(126)	(283)	(13)	(136)	50
Depreciation and amortization expense	126	3	16	—	—	145

	Pro-Dex	OMS	Fineline	ESD	Corporate Unallocated	Total
Three months ended March 31, 2015						
Net Sales	\$ 3,333	\$ 403	\$ 122	\$ 64	\$ —	\$ 3,922
Gross Profit	681	269	43	52	—	1,045
Operating Income (loss)	(77)	52	14	(157)	(222)	(390)
Depreciation and amortization expense	124	3	13	—	—	140

	Pro-Dex	OMS	Fineline	ESD	Corporate Unallocated	Total
Nine months ended March 31, 2016						
Net Sales	\$ 12,846	\$ 673	\$ 930	\$ 424	\$ —	\$ 14,873

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Gross Profit	3,445	315	21	176	—	3,957
Operating Income (loss)	1,595	(270)	(362)	(77)	(559)	327
Depreciation and amortization expense	421	8	52	—	—	481

	Pro-Dex	OMS	Fineline	ESD	Corporate Unallocated	Total
<u>Nine months ended</u>						
March 31, 2015						
Net Sales	\$ 7,994	\$ 1,125	\$ 122	\$ 69	\$ —	\$ 9,310
Gross Profit	1,699	774	43	53	—	2,569
Operating Income (loss)	(644)	480	14	(236)	(587)	(973)
Depreciation and amortization expense	377	8	13	—	—	398

NOTE 15. COMMITMENTS AND CONTINGENCIES

In general, we are from time to time a party to various legal proceedings incidental to our business, none of which we currently consider to 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 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS 2. 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 nine-month periods ended March 31, 2016 and 2015. 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 also 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, 2015.

With operations in California 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. Our products are found in hospitals, dental offices, medical engineering labs, scientific research facilities and high tech manufacturing operations around the world.

In addition to our principal operations described above, our Fineline Molds division, located in San Dimas, California manufactures plastic injection molds for a wide variety of industries. We also provide engineering consulting and

placement services to a wide range of industries through our Engineering Services Division. In addition to Pro-Dex, the names Micro Motors and Oregon Micro Systems are used for marketing purposes as brand names. The names Huber Precision, a division of Pro-Dex, and Fineline Molds, a division of Pro-Dex, are used to distinguish our acquired businesses and we have filed fictitious name statements in the counties in which we operate these divisions. Our Huber Precision division was located in San Carlos, California through November 30, 2015 and after such time we manufacture and ship orders placed from these customers directly from our Irvine, California location.

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

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, 2016. 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.

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.

An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, and if different estimates that reasonably could have been used or changes in the accounting estimate that are reasonably likely to occur could materially change the financial statements. Management believes that there have been no significant changes during the three and nine months ended March 31, 2016 to the items that we disclosed as our critical accounting policies in Management’s Discussion and Analysis of Financial Condition and Results of Operations in our annual report on Form 10-K for the fiscal year ended June 30, 2015, except as noted below, whereby we have expanded our revenue recognition criteria to include the milestone method based upon development contracts in effect during the current fiscal year.

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 either upon milestone completion or completion of the product development services, in conformity with

ASC Section 605. We recognize revenue that is contingent upon the achievement of a substantive milestone in its entirety in the period in which the milestone is achieved. A milestone is considered substantive when the consideration payable to us for such milestone (i) is consistent with our performance necessary to achieve the milestone, (ii) relates solely to our past performance and (iii) is reasonable relative to all of the other deliverables and payments within the arrangement. In making this assessment, we consider all facts and circumstances relevant to the arrangement, including factors such as the scientific, regulatory, commercial and other risks that must be overcome to achieve the milestone, the level of effort and investment required to achieve the milestone and whether any portion of the milestone consideration is related to future performance or deliverables. Accordingly, in certain cases, based upon the evaluation of the criteria above, we record revenue upon milestone completion and in other cases revenue from product development milestone billings to our customers is deferred until completion of all development phases or milestones.

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

Business Strategy and Future Plans

Our business today is almost entirely driven by sales of our medical products and related repair services. One year ago we had one significant medical device customer that accounted for over 10 percent of our revenue and today we have three medical device customers that account for more than 10 percent of our revenue. This is due in part to product shipments beginning in the third quarter of fiscal 2015 that relate to a customer's unique surgical handpiece designed for use in orthopedic surgery applications and the completion of the design of a CMF product which we began selling to a customer in the fourth quarter of fiscal 2015. Product shipments related to these devices are expected to last for at least five to seven years, based upon the term of each underlying supply agreement and both agreements allow for automatic renewals of one to two years. Additionally, in the second quarter of fiscal 2016 we completed the design of another CMF surgical driver for another customer allowing us to recognize previously deferred development revenue and commenced product shipments. Product shipment of this device is expected to last at least seven years based upon the term of the underlying supply agreement. We continue to focus a significant percentage of our time and resources on providing outstanding products and service to our valued principal customers. Additionally, we are currently undertaking cost reduction analysis relating to our newest products, because they have a lower product margin than our legacy products, in part due to additional labor and overhead charges associated with the learning curve of new assemblies. Based upon our current medical device production volumes, we have implemented a second-shift for production which is currently running at approximately 20% capacity. We believe that we can expand our capacity by adding work force to our second shift and may eventually consider a third-shift for production if necessitated.

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 another ongoing engineering project during fiscal 2017, which we believe will lead to the addition of another significant product launch in fiscal 2017 as well. Additionally, we continue to seek additional revenue streams through our Engineering Services Division ("ESD") by offering both temporary/contract and full-time employee placements to other customers in diverse industries.

During fiscal year 2015 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. These acquisitions have helped us to diversify our product offerings and increase the utilization of our machine and assembly departments. Effective November 30, 2015 in conjunction with the termination of the San Carlos lease assumed by us in conjunction with our acquisition of Huber Precision, we have begun manufacturing and shipping orders to Huber Precision customers from our Irvine facility. Additionally, in the third quarter ended March 31, 2016 we performed our annual impairment test for the goodwill and indefinite-lived intangible assets and recorded an impairment charge of \$245,000 related to the acquisition of Fineline Molds.

Finally, during fiscal 2015 and the first quarter of fiscal 2016 we invested \$1.7 million in the land and building located in Ramsey, Minnesota (the "Ramsey Property") and related notes receivable. We originally acquired the notes to achieve a return on capital upon liquidation or operation of the assets of Riverside Manufacturing, Inc. ("Riverside"). We ultimately decided to liquidate the investment and completed the sale of the property and collateral securing the notes receivable during the third quarter ended March 31, 2016 resulting in a gain on the sale of the Investment in

Ramsey in the amount of \$340,000.

In summary, our current objectives are focused primarily on maintaining our relationships with our current medical device customers, completing cost-reductions relating to our newest products, completing our ongoing development projects, and continuing to integrate recent acquisitions while monitoring closely the progress of all these individual endeavors. However, there can be no assurance that we will be successful in any of these objectives.

Description of Business Operations

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 type is as follows (in thousands, except percentages):

Revenue

(in thousands except percentages)

	Three Months Ended March 31,			Nine Months Ended March 31,			2015			2015		
	2016	% of Revenue		2015	% of Revenue		2016	% of Revenue		2015	% of Revenue	
Revenue:												
Medical device and services	\$3,864	73 %		\$2,189	56 %		\$10,521	71 %		\$5,119	55 %	
Industrial and scientific	407	8 %		564	14 %		1,206	8 %		1,604	17 %	
Dental and component	279	5 %		476	12 %		1,044	7 %		1,042	11 %	
Injection molds	444	8 %		122	3 %		930	6 %		122	1 %	
Contract services (ESD)	215	4 %		63	2 %		424	3 %		69	1 %	
Repairs and other	128	2 %		508	13 %		748	5 %		1,354	15 %	
	\$5,337	100 %		\$3,922	100 %		\$14,873	100 %		\$9,310	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. We manufacture plastic injection molds in our San Dimas, California facility, a revenue stream generated from our acquisition of Fineline during the third quarter of fiscal 2015.

Sales of our medical device products and related development services increased \$1.7 million and \$5.4 million, respectively for the three and nine months ended March 31, 2016 compared to the corresponding periods of the prior fiscal year. In the third quarter of fiscal year 2015 we launched production of a surgical handpiece designed to be used in orthopedic surgery applications for one of our customers and in the fourth quarter of fiscal year 2015 we began volume production of a cranial driver for CMF applications that we designed for another customer. Sales to these two customers accounted for \$1.3 million and \$4.5 million for the three and nine months ended March 31, 2016, respectively, and sales to these same customers were negligible during the corresponding periods of the prior fiscal year. During the second quarter of fiscal 2016 we completed the development of another cranial driver to meet the specifications of another medical device customer and we were able to recognize non-recurring engineering revenue,

much of which had been previously deferred, in the amount of \$660,000, and shipped approximately \$930,000 and \$1.5 million of the newly developed product to this customer during the three and nine months ended March 31, 2016. Additionally, sales to another medical device customer increased approximately \$30,000 and \$800,000 during the three and nine months ended March 31, 2016 respectively compared to the corresponding period of the prior fiscal year. These increases in medical device sales to new customers are offset by a decrease in sales of \$800,000 and \$2.1 million in sales to a long-time and significant medical device customer for the three and nine months ended March 31, 2016 compared to the corresponding periods of the prior fiscal year. The decrease in sales to this customer is due in part to a mutual agreement between our customer and us to allow them to take deliveries of existing purchase orders in full over a mutually agreed extended term ending in December, 2016. We believe that the demand for this orthopedic shaver product has declined.

Sales of our industrial and scientific and dental and component revenue have declined in the aggregate \$354,000 and \$396,000 during the three and nine months ended March 31, 2016, respectively, compared to the corresponding periods of the prior year. This is most likely attributable to reduced engineering investment in our legacy dental products as well as a decline in demand of our legacy multi-access motion controllers.

At March, 2016, we had a backlog of approximately \$11.2 million, of which \$6.3 million is scheduled to be delivered in fiscal 2017 and the balance is scheduled to be delivered in the current fiscal year. Of the backlog, approximately \$390,000 relates to Fineline Molds. 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, illustrative of which is two development projects for CMF devices and the recent release of an orthopedic surgical handpiece. 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 March 31,	Nine Months Ended March 31,
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