

PRO DEX INC
Form 10QSB
February 14, 2008
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-QSB

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

For the quarterly period ended December 31, 2007

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 small business issuer as specified in its charter)

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

84-1261240
(IRS Employer Identification No.)

151 E. Columbine Avenue, Santa Ana, California 92707

(Address of Principal Executive Offices)

Issuer's telephone number: 714-241-4411

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

Indicate the number 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: 9,718,366 shares of Common Stock, no par value, as of February 7, 2008.

Transitional Small Business Disclosure Format: Yes No

Item 1. Financial Statements**PRO-DEX, INC. and SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS**

| | <i>December 31, 2007</i> | <i>June 30, 2007</i> |
|---|--------------------------|----------------------|
| | <i>(unaudited)</i> | <i>(audited)</i> |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 220,000 | \$ 403,000 |
| Accounts receivable, net of allowance for doubtful accounts of \$135,000 at December 31 and \$153,000 at June 30 | 3,059,000 | 3,436,000 |
| Inventories, net | 5,007,000 | 4,622,000 |
| Prepaid expenses | 284,000 | 205,000 |
| Deferred income taxes | 1,178,000 | 1,091,000 |
| Total current assets | 9,748,000 | 9,757,000 |
| Property, plant, equipment and leasehold improvements, net | 4,355,000 | 3,778,000 |
| Other assets: | | |
| Goodwill | 2,997,000 | 2,997,000 |
| Intangibles - Patents, net | 1,271,000 | 1,321,000 |
| Deferred income taxes | 229,000 | 229,000 |
| Other | 33,000 | 25,000 |
| Total other assets | 4,530,000 | 4,572,000 |
| Total assets | \$ 18,633,000 | \$ 18,107,000 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Credit Line | \$ - | \$ 300,000 |
| Accounts payable | 1,319,000 | 1,110,000 |
| Accrued expenses | 1,467,000 | 1,183,000 |
| Income taxes payable | 212,000 | 158,000 |
| Current portion of term note | 250,000 | 250,000 |
| Current portion of real estate loan | 29,000 | 26,000 |
| Current portion of "patent" deferred payable | - | 82,000 |
| Total current liabilities | 3,277,000 | 3,109,000 |
| Long-term liabilities | | |
| Term note | 271,000 | 396,000 |
| Real estate loan | 1,576,000 | 1,593,000 |
| Patent deferred payable | - | 158,000 |
| Total long-term liabilities | 1,847,000 | 2,147,000 |
| Total liabilities | 5,124,000 | 5,256,000 |
| Commitments and contingencies | | |
| Shareholders' equity: | | |
| Common shares; no par value; 50,000,000 shares authorized; | | |
| 9,718,366 shares issued and outstanding December 31, 2007, | | |

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| | | |
|--|---------------|---------------|
| 9,718,366 shares issued and outstanding June 30, 2007, | 16,443,000 | 16,340,000 |
| Accumulated deficit | (2,934,000) | (3,489,000) |
| Total shareholders' equity | 13,509,000 | 12,851,000 |
| Total liabilities and shareholders' equity | \$ 18,633,000 | \$ 18,107,000 |

See notes to consolidated financial statements.

PRO-DEX, INC. and SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
Three months ended December 31 (unaudited)

| | 2007 | | 2006 |
|---|--------------|--|--------------|
| Net sales | \$ 6,123,000 | | \$ 4,631,000 |
| Cost of sales | 3,769,000 | | 3,262,000 |
| Gross profit | 2,354,000 | | 1,369,000 |
| Operating expenses: | | | |
| Selling | 352,000 | | 340,000 |
| General and administrative expenses | 866,000 | | 746,000 |
| Research and development costs | 635,000 | | 579,000 |
| Total operating expenses | 1,853,000 | | 1,665,000 |
| (Loss) income from operations | 501,000 | | (296,000) |
| Other income (expense): | | | |
| Other income (expense), net | 48,000 | | - |
| Royalty income | 14,000 | | 18,000 |
| Interest income (expense) | (40,000) | | (58,000) |
| Total | 22,000 | | (40,000) |
| (Loss) income before (benefit) provision for income taxes | 523,000 | | (336,000) |
| (Benefit) provision for income taxes | 218,000 | | (198,000) |
| Net (loss) income | \$ 305,000 | | \$ (138,000) |
| Net (loss) income per share: | | | |
| Basic | \$ 0.03 | | \$ (0.01) |
| Diluted | \$ 0.03 | | \$ (0.01) |
| Weighted average shares outstanding - basic | 9,718,366 | | 9,550,521 |
| Weighted average shares outstanding - diluted | 9,888,356 | | 9,550,521 |

See notes to consolidated financial statements.

PRO-DEX, INC. and SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
Six months ended December 31 (unaudited)

| | 2007 | 2006 |
|--|---------------|--------------|
| Net sales | \$ 12,114,000 | \$ 9,864,000 |
| Cost of sales | 7,608,000 | 6,514,000 |
| Gross profit | 4,506,000 | 3,350,000 |
| Operating expenses: | | |
| Selling | 675,000 | 678,000 |
| General and administrative expenses | 1,601,000 | 1,316,000 |
| Research and development costs | 1,209,000 | 1,226,000 |
| Total operating expenses | 3,485,000 | 3,220,000 |
| Income from operations | 1,021,000 | 130,000 |
| Other income (expense): | | |
| Other income, net | 48,000 | - |
| Royalty income | 20,000 | 25,000 |
| Interest expense, net | (82,000) | (112,000) |
| Total | (14,000) | (87,000) |
| Income before (benefit) provision for income taxes | 1,007,000 | 43,000 |
| (Benefit) provision for income taxes | 376,000 | (60,000) |
| Net income | \$ 631,000 | \$ 103,000 |
| Net Income per share: | | |
| Basic | \$ 0.06 | \$ 0.01 |
| Diluted | \$ 0.06 | \$ 0.01 |
| Weighted average shares outstanding - basic | 9,718,366 | 9,545,757 |
| Weighted average shares outstanding - diluted | 9,926,306 | 9,769,444 |

See notes to consolidated financial statements.

PRO-DEX, INC. and SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
Six months ended December 31 (unaudited)

| | 2007 | 2006 |
|---|------------|------------|
| Cash Flows from Operating Activities: | | |
| Net Income | \$ 631,000 | \$ 103,000 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 243,000 | 232,000 |
| Stock based compensation | 103,000 | 85,000 |
| (Recovery) provision for doubtful accounts | (18,000) | 77,000 |
| Reserve reduction (provision) for obsolete inventory | (173,000) | 200,000 |
| (Decrease) increase in deferred taxes | (87,000) | (305,000) |
| Changes in: | | |
| Decrease in accounts receivable | 395,000 | 422,000 |
| (Increase) in inventories | (212,000) | (963,000) |
| (Increase) in prepaid expenses | (79,000) | (90,000) |
| (Increase) in other assets | (8,000) | (30,000) |
| Increase in accounts payable and accrued expenses | 417,000 | 346,000 |
| Increase in income taxes payable | 54,000 | 127,000 |
| Net Cash provided by Operating Activities | 1,266,000 | 204,000 |
| Cash Flows From Investing Activities: | | |
| Additions to Astromec acquisition cost | - | (66,000) |
| Additions to Intangible assets - Patents related to Intraflow | - | (2,000) |
| Purchases of equipment and leasehold improvements | (770,000) | (217,000) |
| Net Cash used in Investing Activities | (770,000) | (285,000) |
| Cash Flows from Financing Activities: | | |
| Net (payments) borrowing on line of credit | (300,000) | 300,000 |
| Principal (payments) on term note | (125,000) | (125,000) |
| Principal (payments) on mortgage | (14,000) | (13,000) |
| Principal (payment) on patent deferred payable | (240,000) | (76,000) |
| Proceeds from option exercise | - | 3,000 |
| Net Cash provided by Financing Activities | (679,000) | 89,000 |
| Net Increase (decrease) in Cash and Cash Equivalents | (183,000) | 8,000 |
| Cash and Cash Equivalents, beginning of period | 403,000 | 358,000 |
| Cash and Cash Equivalents, end of period | \$ 220,000 | \$ 366,000 |
| <i>Supplemental Information</i> | | |
| Cash payments for interest | \$ 95,000 | \$ 150,000 |
| Cash payments for income taxes | \$ 560,000 | \$ 137,000 |

See notes to consolidated financial statements.

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PRO-DEX, INC. AND SUBSIDIARIES**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****NOTE 1. Basis of Presentation**

The accompanying unaudited consolidated financial statements of Pro-Dex, Inc. (we , us , our , Pro-Dex or the "Company") have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-QSB and Regulation S-B. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. These financial statements should be read in conjunction with the audited financial statements presented in our Annual Report for the fiscal year ended June 30, 2007. 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 the Company's Annual Report on Form 10-KSB for the year ended June 30, 2007.

NOTE 2. Inventories

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

| | December 31, 2007 (unaudited) | June 30, 2007 |
|--|----------------------------------|---------------|
| Raw Materials | \$ 2,306,000 | \$ 2,474,000 |
| Work in process | 1,179,000 | 594,000 |
| Development costs under contract | 41,000 | 141,000 |
| Finished goods | 2,298,000 | 2,403,000 |
| Total | \$ 5,824,000 | \$ 5,612,000 |
| Reserve for slow moving and obsolete items | (817,000) | (990,000) |
| Total inventories, net | \$ 5,007,000 | \$ 4,622,000 |

NOTE 3. WARRANTY

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The warranty reserve is based on historical costs of warranty repairs and expected future identifiable warranty expenses. As of December 31, 2007 we carried a warranty reserve of \$534,000 which was comprised of \$36,000 for future warranty expenses related to products that are currently in the process of being repaired and \$456,000 for future warranty expenses related to products that are still in the field, and \$42,000 for our legacy dental and industrial products. Warranty expenses are reflected in the financial statements in cost of sales (COS). The total warranty expense reflected in the COS for the quarter ended December 31, 2007 was \$238,000 and for the six-months ended December 31, 2007 was \$605,000. The warranty accrual and expenses for the three and six-months ended December 31, 2007 and 2006 are presented below:

| | Three months Ended December 31, | |
|---------------------|---------------------------------|--------------|
| | 2007 | 2006 |
| Beginning Balance | \$ 443,000 | \$ 321,000 |
| Actual expenditures | \$ (147,000) | \$ (296,000) |
| Additional accrual | \$ 238,000 | \$ 311,000 |
| Ending Balance | \$ 534,000 | \$ 336,000 |

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| | Six months Ended December 31, | | | |
|---------------------|-------------------------------|-----------|------|-----------|
| | 2007 | | 2006 | |
| Beginning Balance | \$ | 469,000 | \$ | 309,000 |
| Actual expenditures | \$ | (540,000) | \$ | (476,000) |
| Additional accrual | \$ | 605,000 | \$ | 503,000 |
| Ending Balance | \$ | 534,000 | \$ | 336,000 |

NOTE 4. Net INCOME (LOSS) per share

The following table reconciles the weighted average shares outstanding for basic and diluted net income per share for the periods indicated.

| | Three Months Ended December 31, | | |
|---|---------------------------------|-----------|--------------|
| | 2007 | | 2006 |
| Net (loss) income | \$ | 305,000 | \$ (138,000) |
| Basic net income per common share: | | | |
| Weighted average number of common shares outstanding | | 9,718,366 | 9,550,521 |
| Basic net (loss) income per common share | \$ | 0.03 | \$ (0.01) |
| Diluted net (loss) income per share: | | | |
| Weighted average of common shares outstanding | | 9,718,366 | 9,550,521 |
| Effect of potentially dilutive securities (options) | | 155,698 | - |
| Effect of potentially dilutive securities (restricted shares) | | 6,375 | - |
| Effect of potentially dilutive securities (warrants) | | 7,917 | - |
| Weighted average number of common and shares - Diluted | | 9,888,356 | 9,550,521 |
| Diluted net (loss) income per common share | \$ | 0.03 | \$ (0.01) |

| | Six Months Ended December 31, | | |
|--|-------------------------------|-----------|------------|
| | 2007 | | 2006 |
| Net income | \$ | 631,000 | \$ 103,000 |
| Basic net income per common share: | | | |
| Weighted average number of common shares outstanding | | 9,718,366 | 9,545,757 |
| Basic net income per common share | \$ | 0.06 | \$ 0.01 |
| Diluted net income per share: | | | |
| Weighted average of common shares outstanding | | 9,718,366 | 9,545,757 |
| Effect of potentially dilutive securities (options) | | 176,244 | 215,770 |

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| | | |
|---|-----------|-----------|
| Effect of potentially dilutive securities (restricted shares) | 21,038 | |
| Effect of potentially dilutive securities (warrants) | 10,658 | 7,917 |
| Weighted average number of common and shares - Diluted | 9,926,306 | 9,769,444 |
| Diluted net income per common share | \$ 0.06 | \$ 0.01 |

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NOTE 5. CREDIT FACILITIES

On November 1, 2007, our existing credit facility with Wells Fargo was replaced with an expanded facility with a total borrowing capacity of \$6,562,500. The credit line increases our borrowing availability from \$2,000,000 to \$4,000,000. Its terms require monthly interest payments at the prime rate of interest (7.25% at December 31, 2007); or LIBOR (4.6% at December 31, 2007) plus 1.75%, at our discretion, based on outstanding borrowings. The credit facility expires on November 1, 2009. An additional term commitment is available for borrowings through November 1, 2008 for amounts up to \$2,000,000. We can take advances against this commitment through November 1, 2008, at which time the outstanding borrowings against this commitment will be converted to a term loan to be amortized and repaid over 60 months. Its terms require monthly interest payments at the prime rate of interest; or LIBOR plus 2.0%, at our discretion, based on outstanding borrowings. It is anticipated that the borrowings from the term commitment will be used for construction financing of tenant improvements for our new Irvine facility. The term loan that was entered into in January 2006 to finance the purchase of our Astromec subsidiary remains in place. As of December 31, 2007, there was a principal balance of \$520,833 to be fully paid off in January 2010, following the contracted amortization schedule. Its terms require monthly interest payments at the prime rate of interest; or LIBOR plus 2.0%, at our discretion, based on outstanding borrowings with no minimum interest charge. All assets of the Company except our Carson City land and building secure the outstanding borrowings from Wells Fargo. There was no outstanding balance under the terms of the credit line or term commitment facility as of December 31, 2007. The total eligible additional borrowing capacity at December 31, 2007 was \$6,000,000.

In March 2006, we entered into a 10-year mortgage with Union Bank of California for \$1,650,000. Its terms require monthly interest payments at a fixed rate of 6.73% based on outstanding borrowings. The principal payments on the mortgage note are based on a 25-year amortization of the note and are \$11,000 per month beginning May 1, 2006. The outstanding borrowings are secured by our Carson City land and building. There was approximately \$1,605,000 outstanding balance under the terms of this mortgage as of December 31, 2007.

There are certain financial and non-financial covenants that we must meet to be in compliance with the terms of the Wells Fargo credit facility (which includes the term loan and the line of credit), as amended, and the Union Bank mortgage. At December 31, 2007, management believes that the Company was in compliance with all such covenants.

NOTE 7. Income Taxes

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

tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment. We have tax credit carry forwards totaling \$201,000 for state tax purposes that do not expire and can be carried forward indefinitely until fully utilized.

Significant management judgment is required in determining our provision for income taxes and the recoverability of our deferred tax asset. Such determination is based on our estimates of future taxable income by jurisdiction in which we operate and the period over which our deferred tax assets will be recoverable. In the event that actual results differ from these estimates or we adjust these estimates in future periods, we may need to establish a valuation allowance, which could result in a tax provision up to the carrying value of our deferred tax assets.

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, (FIN 48), an interpretation of FASB Statement No. 109, Accounting for Income Taxes, (FASB 109). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB 109. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The cumulative effect of applying FIN 48 is to be reported as an adjustment to the opening balance of retained earnings in the year of adoption. As a result of the implementation of FIN 48, the Company recorded a decrease of \$75,000 to retained earnings, an increase of \$47,000 to net deferred income tax assets and an increase of \$122,000 to income taxes payable as of July 1, 2007.

As of December 31, 2007, the Company has provided a liability for \$240,000 of unrecognized tax benefits related to various federal and state income tax matters. Of this total, \$62,000 relates to R&D credits and would reduce the Company's income tax expense if recognized and would result in a corresponding decrease in the Company's effective tax rate.

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

| | |
|--|-----------|
| Balance at July 1, 2007 | \$212,000 |
| Additions based on tax positions related to the current year | 0 |
| Additions for tax positions of prior years | \$28,000 |
| Reductions for tax positions of prior years | 0 |
| Settlements | 0 |
| | ----- |
| Balance at December 31, 2007 | \$240,000 |

The Company recognizes accrued interest and penalties related to unrecognized tax benefits in income tax expense. As of December 31, 2007, the Company had approximately \$178,000 in accrued interest and penalties which is included as a component of the \$240,000 unrecognized tax benefit noted above. The liability for the payment of interest and penalties has increased by approximately \$33,000 for the six months ended December 31, 2007.

The Company and its subsidiary are subject to U.S. federal income tax, and are currently under audit by the Internal Revenue Service for the years ended June 30, 2004 through June 30, 2006. It is reasonably possible that the examination phase of the audit for these years may conclude in the next 12 months. The Company believes the

appropriate provisions for all outstanding issues have been made for all years under audit.

The Company and its subsidiary are subject to income tax of multiple state tax jurisdictions. The Company and its subsidiary state income tax returns are open to audit under the statute of limitations for the years ended June 30, 2003 through June 30, 2007. The company does not anticipate a significant change to the total amount of unrecognized tax benefits within the next 12 months.

NOTE 8. SHARE-BASED COMPENSATION

Share-based compensation expense recognized under SFAS 123(R) for the three months ended December 31, 2007 and 2006 was \$54,000 and \$52,000, respectively, which was related to stock options and restricted stock grants in 2007 and stock options and stock appreciation rights in 2006. Share-based compensation expense reduced our results of operations as shown:

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| | Three months ended December 31, (unaudited) | |
|--|--|---------|
| | 2007 | 2006 |
| Share-based compensation expense recognized: | | |
| General and administrative, options | 25,000 | 35,000 |
| General and administrative, restricted stock | 29,000 | - |
| General and administrative, SAR's | - | 17,000 |
| Subtotal expense | 54,000 | 52,000 |
| Related deferred tax benefit | (12,000) | - |
| Decrease in net income | 42,000 | 52,000 |
| Decrease in basic earnings per share | \$ 0.00 | \$ 0.01 |
| Decrease in diluted earnings per share | \$ 0.00 | \$ 0.01 |

Share-based compensation expense recognized under SFAS 123(R) for the six months ended December 31, 2007 and 2006 was \$103,000 and \$85,000, respectively, which was related to stock options and restricted stock grants in 2007 and stock options and stock appreciation rights in 2006. Share-based compensation expense reduced our results of operations as shown:

| | Six months ended December 31, (unaudited) | |
|--|--|---------|
| | 2007 | 2006 |
| Share-based compensation expense recognized: | | |
| General and administrative, options | 44,000 | 52,000 |
| General and administrative, restricted stock | 59,000 | - |
| General and administrative, SAR's | - | 33,000 |
| Subtotal expense | 103,000 | 85,000 |
| Related deferred tax benefit | (24,000) | - |
| Decrease in net income | 79,000 | 85,000 |
| Decrease in basic earnings per share | \$ 0.01 | \$ 0.01 |
| Decrease in diluted earnings per share | \$ 0.01 | \$ 0.01 |

As of December 31, 2007, there was \$138,407 of total unrecognized compensation cost related to 226,750 non-vested outstanding stock options with a per share weighted average value of \$0.91. The unrecognized expense is anticipated to be recognized on a straight-line basis over a weighted average period of 1.0 year. The following is a summary of stock option activity in the six months ending December 31:

| 2007 | Weighted- | 2006 | Weighted- |
|------|-----------|------|-----------|
|------|-----------|------|-----------|

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| Fixed Options | Shares | Average Exercise Price | Shares | Average Exercise Price |
|---|-----------|---------------------------|-----------|---------------------------|
| Outstanding at beginning of fiscal year (7/1) | 1,038,500 | \$ 1.60 | 1,204,316 | \$ 1.68 |
| Granted | 71,000 | 1.51 | 71,000 | 1.52 |
| Exercised | - | - | (25,000) | 0.77 |
| Forfeited | - | - | (85,000) | 2.28 |
| Outstanding at end of period (12/31) | 1,109,500 | \$ 1.59 | 1,165,316 | \$ 1.65 |
| Exercisable at end of period (12/31) | 882,750 | \$ 1.56 | 916,816 | \$ 1.47 |
| Weighted-average fair value per Option granted during the period | | \$ 0.77 | | \$ 0.88 |

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The following table summarizes information regarding options outstanding and options exercisable at December 31, 2007:

| Range of Exercise Price | Number Outstanding | Options Outstanding | | | Options Exercisable | | |
|-------------------------|--------------------|---|---------------------------------|---------------------------|---------------------------------|---------------------------|------------|
| | | Weighted-Average Remaining Contractual Life | Weighted-Average Exercise Price | Aggregate Intrinsic Value | Weighted-Average Exercise Price | Aggregate Intrinsic Value | |
| \$0.42 to \$0.81 | 260,000 | 4.2 years | \$ 0.70 | \$ 195,400 | 260,000 | \$ 0.70 | \$ 195,400 |
| \$1.08 to \$1.56 | 412,000 | 6.8 years | 1.37 | \$ 40,500 | 241,500 | 1.29 | \$ 40,500 |
| \$1.74 to \$2.18 | 262,500 | 3.9 years | 2.04 | \$ - | 248,750 | 2.05 | \$ - |
| \$2.44 to \$3.30 | 175,000 | 7.5 years | 2.77 | \$ - | 132,500 | 2.83 | \$ - |
| Total | 1,109,500 | 5.6 years | \$ 1.59 | \$ 235,900 | 882,750 | \$ 1.56 | \$ 235,900 |

Restricted Stock

The following is a summary of restricted share activity in the six months ending December 31:

| | 2007 | | 2006 | |
|---|---------|---------------------------------|--------|---------------------------------|
| | Shares | Weighted-Average Exercise Price | Shares | Weighted-Average Exercise Price |
| Restricted shares | | | | |
| Outstanding at beginning of fiscal year (7/1) | 255,000 | \$ 1.38 | - | \$ - |
| Granted | - | - | - | - |
| Exercised | - | - | - | - |
| Forfeited | - | - | - | - |
| Outstanding at end of period (12/31) | 255,000 | \$ 1.38 | - | \$ - |
| Exercisable at end of period (12/31) | - | \$ - | - | \$ - |

As of December 31, 2007, there was \$254,000 of total unrecognized compensation cost related to 184,167 non vested outstanding restricted shares with a per share weighted average value of \$1.38. The unrecognized expense is anticipated to be recognized on a straight-line basis over a weighted average period of 2.2 years.

Stock Warrants

At December 31, 2007, warrants to acquire 100,000 shares of common stock were outstanding. These warrants are fully vested, have a weighted-average exercise price of \$1.25 and a weighted-average remaining life of 1.5 years.

NOTE 9. MAJOR CUSTOMERS

We had two major customers (defined as a customer that represents greater than 10% of the Company's total revenues) in the six months ended December 31, 2007 and 2006.

| | Six months ended December 31, (unaudited) | | | |
|------------|--|-------------|--------------|-------------|
| | 2007 | | 2006 | |
| | Revenues | Accts. Rec. | Revenues | Accts. Rec. |
| Customer 1 | \$ 2,569,000 | \$ 520,000 | \$ 1,776,000 | \$ 902,000 |
| Customer 2 | \$ 3,083,000 | \$ 701,000 | \$ 2,033,000 | \$ 388,000 |

NOTE 10. COMMITMENTS AND CONTINGENCIES

Our manufacture and distribution of certain products involves a risk of legal action, and, from time to time, we are named as defendants in lawsuits. It is not reasonably possible to estimate the awards or damages, or the range of awards or damages, if any, we might incur in connection with such litigation. Management is not aware of any material actual, pending or threatened litigation at this time.

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

COMPANY OVERVIEW

The following discussion and analysis provides information that the Company's management believes is relevant to an assessment and understanding of our results of operations and financial condition for each of the three and six month periods ended December 31, 2007 and 2006, respectively. This discussion should be read in conjunction with the Consolidated Financial Statements and the Notes thereto included elsewhere in this Report. This Report contains certain forward-looking statements and information. The cautionary statements included herein should be read as being applicable to all related forward-looking statements wherever they may appear. Our actual future results could differ materially from those discussed herein. Our critical accounting policies relate to inventory valuation for slow moving items, impairment of goodwill, warranty reserves, and recoverability of deferred income taxes.

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

Pro-Dex, Inc. (Company, Pro-Dex , we, our, , us), with operations in Santa Ana, California, Beaverton, Oregon and Carson City, Nevada, specializes in bringing speed to market in the development and manufacture of technology-based solutions that incorporate embedded motion control, miniature rotary drive systems and fractional horsepower DC motors, serving the medical, dental, semi-conductor, scientific research and aerospace markets. Pro-Dex's products are found in hospitals, dental offices, medical engineering labs, commercial and military aircraft, scientific research facilities and high tech manufacturing operations around the world. The company names of Micro Motors, Oregon Micro Systems, and Astromec are used for marketing purposes as brand names.

Pro-Dex's principal headquarters are located at 151 E. Columbine Avenue, Santa Ana, California 92707 and our phone number is 714-241-4411. Our Internet address is www.pro-dex.com. Our annual reports on Form 10-KSB, quarterly reports on Form 10-QSB, current reports on Form 8-K, amendments to those reports and other Securities and Exchange Commission (SEC) filings, are available free of charge through 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.

Description of Business

The majority of our revenue is derived from designing, developing and manufacturing rotary drive systems for the medical device and dental industries, motion control software and hardware for industrial and scientific applications and fractional horsepower DC motors for aerospace, medical and military applications. A large part of the revenue of the Company has been driven by developing and selling numerous types of private label rotary drive systems for use in dental, cranial, spinal, arthroscopic and orthopedic surgery. The Company distributes its own line of pneumatic and electric dental hand pieces sold under the Micro Motors name utilizing a network of independent sales representatives across North America. Other revenue sources include designing and manufacturing miniature pneumatic motors, fractional horsepower DC motors and motion control systems for industrial applications in the automotive, aerospace, and apparel industries.

All years relating to financial data herein shall refer to fiscal years ending June 30, unless indicated otherwise.

Company-funded research and development supports the development of generic rotary drive, motion control, and electric motor technology platforms. The costs of which are expensed when incurred. We seek customer-funded projects to customize these platforms to specific customer requirements. Company-funded research and development projects are generally expected to convert to customer-funded projects within six to eighteen months. Company funded project costs not associated with contracts or purchase orders are expensed as incurred. In the three months ended December 31, 2007, \$635,000 was expensed as research and development; an increase of \$56,000 from the \$579,000 expensed in the three months ended December 31, 2006.

For customer-funded development projects, costs are capitalized and recognized as a cost of sales when specific deliverables within the development contracts are earned, matching the costs to the revenue. Customer-funded research and development provided \$208,000 in revenue for the three months ended December 31, 2007, compared to a reduction in revenue of \$61,000 for the three months ended December 31, 2006, reflecting an increase in development fees billable on new projects in the current quarter and the net effect of an \$84,000 refunded development fee in the quarter ended December 31, 2006. In the three months ended December 31, 2007, \$39,000 was recognized as cost of sales for non recurring engineering work, compared to \$86,000 recognized as cost of sales in the three months ended December 31, 2006, consistent with the increase in development fees billable during the quarter and absent the higher costs associated with completed and cancelled contracts from the prior year. The results of customer-funded development work are intended to provide long-term exclusive manufacturing agreements and may provide the customer with the retention of the intellectual property developed. The identity of our customers is generally protected by a non-disclosure agreement.

The Company's revenue is derived from five main customer types. The proportion of total sales compared sales to each customer type and sales by location is noted in the table below (unaudited):

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| Sales by customer type (\$'000) | Three months Ended December 31, | | | | Six months Ended December 31, | | | |
|---------------------------------|---------------------------------|------|----------|------|-------------------------------|------|----------|------|
| | 2007 | | 2006 | | 2007 | | 2006 | |
| Dental | \$ 786 | 13% | \$ 1,109 | 24% | \$ 1,749 | 14% | \$ 2,187 | 22% |
| Medical | 3,519 | 57% | 1,681 | 36% | 6,725 | 56% | 3,850 | 39% |
| Industrial | 919 | 15% | 879 | 19% | 1,631 | 13% | 1,761 | 18% |
| Aerospace | 422 | 7% | 557 | 12% | 985 | 8% | 1,147 | 12% |
| Government, repairs and other | 477 | 8% | 405 | 9% | 1,024 | 8% | 919 | 9% |
| Total Sales | \$ 6,123 | 100% | \$ 4,631 | 100% | \$ 12,114 | 100% | \$ 9,864 | 100% |

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| Sales by location (\$'000) | Three Months Ended December 31, | | | | Six Months Ended December 31, | | | |
|----------------------------|---------------------------------|------|----------|------|-------------------------------|------|----------|------|
| | 2007 | | 2006 | | 2007 | | 2006 | |
| Santa Ana | \$ 4,602 | 75% | \$ 2,765 | 60% | \$ 8,738 | 72% | \$ 6,026 | 61% |
| Beaverton | 851 | 14% | 1,005 | 22% | 1,837 | 15% | 2,061 | 21% |
| Carson City | 670 | 11% | 861 | 19% | 1,539 | 13% | 1,777 | 18% |
| Total Sales | \$ 6,123 | 100% | \$ 4,631 | 100% | \$ 12,114 | 100% | \$ 9,864 | 100% |

Medical product sales represent the manufacture of products that utilize proprietary designs developed by us under exclusive design and supply agreements. Our dental products are primarily sold to original equipment manufacturers and dental product distributors. An independent dealer network markets our own branded line of dental products; including the Intraflow™ dental anesthesia product we acquired the rights to in October 2005. We also design and manufacture embedded multi-axis motion controllers used to regulate the motion of servo and stepper motors, predominantly for the factory automation, scientific research, and medical analysis equipment industries. The controllers support the platforms for PCI, VME, ISA, and cPCI busses as well as stand-alone requirements. In addition, we make and sell pneumatic motors for industrial applications that are marketed directly to end-users and through industrial supply distributors. We added significant sales with the purchase of the assets of Astromec, Inc., and the establishment Pro-Dex Astromec, Inc. in January 2006. Pro-Dex Astromec's products include high reliability fractional horsepower DC motors designed for harsh environments primarily for the aerospace and medical markets.

We hold the following three independently verified certifications: ISO 9001:2000, ISO 13485 revised 1998, and Medical Device Directive 93/42/EEC Annex II company.

At the present time, we are generally able to fill orders within sixty (60) days. At December 31, 2007, we had a backlog, including orders for delivery beyond 60 days, of \$11.7 million compared with a backlog of \$11.7 million at December 31, 2006 and \$10.1 million at June 30, 2007. We expect to ship most of our backlog in fiscal year 2008 and the remainder in fiscal year 2009. The steady backlog compared to December 2006 and the increase from June 2007 is due to normal fluctuations in the timing of receipt and shipment of orders. We do not typically experience seasonal fluctuations in our new order bookings, but may experience variability in our new order bookings due to the timing of major new product launches. Similarly, we do not typically experience seasonal fluctuations in our shipments and revenues.

Results of Operations

For the Three-Month periods ended December 31, 2007 and 2006

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

| (In Thousands) | Three Months Ended December 31, | | | | | |
|--|---------------------------------|-------|------|----|-------|------|
| | 2007 | | 2006 | | | |
| Net sales: | \$ | 6,123 | 100% | \$ | 4,631 | 100% |
| Cost of sales | | 3,769 | 62% | | 3,262 | 70% |
| Gross Profit | | 2,354 | 38% | | 1,369 | 30% |
| Selling, general and administrative expenses | | 1,218 | 20% | | 1,086 | 23% |
| Research and development costs | | 635 | 10% | | 579 | 13% |
| Income (Loss) from Operations | | 501 | 8% | | (296) | -6% |
| Net interest and other income (expense) | | 22 | 0% | | (40) | -1% |
| Provision (benefit) for income taxes | | 218 | 4% | | (198) | -4% |
| Net income (loss) | \$ | 305 | 5% | \$ | (138) | -3% |

Net Sales. Consolidated sales increased from \$4,631,000 to \$6,123,000 (\$1,492,000 or 32%) for the quarter ended December 31, 2007 compared to the quarter ended December 31, 2006. The increase was due to continued growth in medical product sales, offsetting declines in revenues for the other product lines.

Although selective price increases and decreases were implemented in response to market conditions, the majority of the sales changes for each product line are due primarily to changes in sales volume, not the effect of price changes.

Gross Profit and Gross Profit Percentage of Sales. Our consolidated gross profit for the quarter ended December 31, 2007 increased \$985,000 or 72% over the same quarter in the previous year due to the higher level of sales and increased profitability in medical products. Fiscal year 2008 included over \$200,000 in profitable development fees, where 2007 had \$40,000 in fees billed at a loss. Gross profit as a percentage of sales increased to 38% for the quarter ended December 31, 2007 compared to 30% for the quarter ended December 31, 2006. Gross profit margins were enhanced 3% by the development fees, 2% by better manufacturing cost controls and 3% by increased manufacturing efficiencies. Warranty costs accounted for approximately 5% reduction in margin in each quarter. Gross profit and gross profit as a percentage of sales were as follows:

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| | Three Months Ended December 31, | | | Increase |
|----------------------------------|---------------------------------|--------------|--|----------|
| | 2007 | 2006 | | |
| Gross Profit | \$ 2,354,000 | \$ 1,369,000 | | 72% |
| Gross Profit Percentage of Sales | 38% | 30% | | |

Selling, General and Administrative Costs (S, G&A). Consolidated S, G & A expenses increased to \$1,218,000 for the quarter ended December 31, 2007 from \$1,087,000 for the quarter ended December 31, 2006. The increase in selling expense is mainly due to higher labor costs (\$92,000) offset primarily by lower bad debt (\$43,000) and advertising costs (\$22,000). The increase in S, G & A costs was due to higher labor (\$104,000) and information technology support costs (\$23,000). As a percentage of sales, S, G&A expenses decreased to 20% of sales from 23% of sales for the quarter ended December 31, 2007 and 2006 respectively. S, G&A costs were as follows:

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| | Three Months Ended December 31, | | Increase (Decrease) |
|----------------------------|---------------------------------|--------------|------------------------|
| | 2007 | 2006 | |
| Selling | \$ 352,000 | \$ 340,000 | 4% |
| General and administrative | \$ 866,000 | \$ 746,000 | 16% |
| Total S, G&A | \$ 1,218,000 | \$ 1,086,000 | 12% |
| S, G&A Percentage of Sales | 20% | 23% | |

Research and Development (R&D) Costs. Company-funded research and development expenses increased \$56,000 to \$635,000 for the quarter ended December 31, 2007 from \$579,000 for the quarter ended December 31, 2006, an increase of 10%. The increase was due to approximately \$38,000 in higher labor costs and \$9,000 for increased independent research costs to support the higher activity levels. Company-funded research and development costs were as follows:

| | Three Months Ended December 31, | | Increase |
|--------------------------------|---------------------------------|------------|----------|
| | 2007 | 2006 | |
| Research and Development costs | \$ 635,000 | \$ 579,000 | 10% |
| R & D Percentage of Sales | 10% | 13% | |

Operating Profit (loss) and Operating Profit (loss) Percentage of Sales. Our consolidated operating profit for the quarter ended December 31, 2007 increased to a profit of \$501,000 compared to an operating loss of \$296,000 for the same quarter in the previous year. The increase in operating profit was due to the higher sales and gross margin coupled with the controlled growth in S, G&A and research and development expenses. Consequently, operating profit as a percentage of sales increased to 8% for the quarter ended December 31, 2007 compared to -6% for the quarter ended December 31, 2006. Operating profit and margin were as follows:

| | Three Months Ended December 31, | | Increase (Decrease) |
|---|---------------------------------|--------------|------------------------|
| | 2007 | 2006 | |
| Operating Profit (loss) | \$ 501,000 | \$ (296,000) | 269% |
| Operating Profit (loss) Percentage of Sales | 8% | -6% | |

Royalties and Other Income. We received \$14,000 in royalty income in the three months ended December 31, 2007, compared to \$18,000 in the same period during the prior year. We recognized an additional \$48,000 in income in the three months ended December 31, 2007 for gains associated with early and discounted payment of debt related to the Intravantage deferred payables.

Net Interest Expense. Net interest expense for the quarter ended December 31, 2007 was \$41,000 compared to \$58,000 in the quarter ended December 31, 2006, due to higher cash balances maintained through the quarter and the early payment of the Intravantage deferred payables.

Income Tax (Benefit) Provision. Our estimated effective combined federal and state tax rate on income from operations for the quarter ended December 31, 2007 resulted in a 42% provision of earnings before tax compared to a benefit of 70% of earnings before tax for the quarter ended December 31, 2006. The difference in the 2007 rate is due to the prior year's operating loss combined with the use of state tax credits and a retroactive reinstatement of the federal research and development credit for \$64,000. The reinstatement was for expenses incurred after December 31, 2005.

Net Income/loss. Our net income for the three months ended December 31, 2007 was \$305,000 or \$0.03 per share on a basic and diluted basis, as compared to a net loss of \$138,000 or \$0.01 per share on a basic and diluted basis for the three months ended December 31, 2006.

For the Six-Month periods ended December 31, 2007 and 2006

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

| (In Thousands) | Six Months Ended December 31, | | | |
|--|-------------------------------|------|----------|------|
| | 2007 | | 2006 | |
| Net sales: | \$ 12,114 | 100% | \$ 9,864 | 100% |
| Cost of sales | 7,608 | 63% | 6,514 | 66% |
| Gross Profit | 4,506 | 37% | 3,350 | 34% |
| Selling, general and administrative expenses | 2,276 | 19% | 1,994 | 20% |
| Research and development costs | 1,209 | 10% | 1,226 | 12% |
| Income from Operations | 1,021 | 8% | 130 | 1% |
| Net interest and other expense | (14) | 0% | (87) | -1% |
| Provision (benefit) for income taxes | 376 | 3% | (60) | -1% |
| Net Income | \$ 631 | 5% | \$ 103 | 1% |

Net Sales. Consolidated net sales increased to \$12,114,000 from \$9,864,000 (\$2,250,000 or 23%) for the six months ended December 31, 2007, compared to the six months ended December 31, 2006. Increases in medical shipments of \$2,875,000 more than offset the combined decreases in dental, industrial and aerospace shipments of \$730,000.

Although selective price increases and decreases were implemented in response to market conditions, the majority of the sales changes for each product line are due primarily to changes in sales volume, not the effect of price changes.

Gross Profit and Gross Profit Percentage of Sales. Our consolidated gross profit for the six months ended December 31, 2007 increased \$1,156,000 or 35% over the same period in the previous year due to the higher sales levels of medical products and stable warranty expenses. Gross profit as a percentage of sales increased to 37% for

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the six months ended December 31, 2007 compared to 34% for the six months ended December 31, 2006. Gross profit margins were enhanced 1% by development fees, 1% by better manufacturing cost controls and 1% by increased manufacturing efficiencies. Warranty costs represented approximately 5% of sales in each period. Gross profit and gross profit as a percentage of sales were as follows:

| | Six Months Ended December 31, | | | |
|----------------------------------|-------------------------------|--------------|--|----------|
| | 2007 | 2006 | | Increase |
| Gross Profit | \$ 4,506,000 | \$ 3,350,000 | | 35% |
| Gross Profit Percentage of Sales | 37% | 34% | | |

Selling, General and Administrative Costs (S, G&A). Consolidated S, G & A expenses increased to \$2,276,000 for the six months ended December 31, 2007 from \$1,994,000 for the six months ended December 31, 2006. The majority of the increase is due to increases in labor and labor related expenses including FAS 123 (R) expenses of \$196,000. There was \$59,000 in higher building occupancy and IT expenses at the Santa Ana facility as it is in a holdover rental period under its leasehold with higher than market rates, and with the remainder of the increase due to higher legal fees. As a percentage of sales, S, G&A expenses decreased to 19% of sales from 20% of sales. S, G & A costs were as follows:

| | Six Months Ended December 31, | | | Increase |
|----------------------------|-------------------------------|--------------|--|----------|
| | 2007 | 2006 | | |
| Selling | \$ 675,000 | \$ 678,000 | | 0% |
| General and administrative | \$ 1,601,000 | \$ 1,316,000 | | 22% |
| Total S, G&A | \$ 2,276,000 | \$ 1,994,000 | | 14% |
| S, G&A Percentage of Sales | 19% | 20% | | |

Research and Development (R&D) Costs. Company-funded research and development expenses decreased \$17,000 to \$1,209,000 for the six months ended December 31, 2007 from \$1,226,000 for the six months ended December 31, 2006, a decrease of 1%. The decrease was due to reduced independent research at the Beaverton location. Company-funded research and development costs were as follows:

| | Six Months Ended December 31, | | | (Decrease) |
|--------------------------------|-------------------------------|--------------|--|------------|
| | 2007 | 2006 | | |
| Research and Development costs | \$ 1,209,000 | \$ 1,226,000 | | -1% |
| R & D Percentage of Sales | 10% | 12% | | |

Operating Profit and Operating Profit Percentage of Sales. Our consolidated operating profit for the six months ended December 31, 2007 increased to \$1,021,000 compared to \$130,000 for the same period in the previous year. The increase in operating profit was due to the higher sales and gross margin coupled with the controlled growth in S, G&A and research and development expenses. Consequently, operating profit as a percentage of sales increased to 8% for the six months ended December 31, 2007 compared to 1% for the six months ended December 31, 2006.

Operating profit and margin were as follows:

| | Six Months Ended December 31, | | | Increase |
|--------------------------------------|-------------------------------|------------|--|----------|
| | 2007 | 2006 | | |
| Operating Profit | \$ 1,021,000 | \$ 130,000 | | 685% |
| Operating Profit Percentage of Sales | 8% | 1% | | |

Royalties and Other Income. We received \$20,000 in royalty payments in the six months ended December 31, 2007, compared to \$25,000 in royalty payments in the six months ended December 31, 2006. We recognized an additional \$48,000 in income in the six months ended December 31, 2007 for gains associated with early and discounted payment of debt related to the Intravantage deferred payables.

Net Interest Income/Expense. Net interest expense for the six months ending December 31, 2007 was \$82,000 compared to net interest expense of \$112,000 in the six months ended December 31, 2006, due to higher cash balances maintained through the quarter and the early payment of the Intravantage deferred payables.

Income Tax (Benefit) Provision. Our estimated effective combined federal and state tax rate on income from operations for the six months ended December 31, 2007 resulted in a provision 37% of earnings before tax compared to a 140% benefit of earnings before tax for the six months ended December 31, 2006. The difference in the 2006 rate is due to the use of state tax credits coupled with a retroactive reinstatement of the federal research and development credit of \$64,000. The reinstatement was for expenses incurred after December 31, 2005.

Net Income. Our net income for the six months ended December 31, 2007 was \$631,000 or \$0.06 per share on a basic and diluted basis, as compared to a net income of \$103,000 or \$0.01 per share on a basic and diluted basis for the six months ended December 31, 2006.

Liquidity and Capital Resources

The following table presents selected financial information as of the end of the second quarters of fiscal 2008 and 2007 as well as of the year ended June 30, 2007:

| | As of December 31, | | As of |
|---|-------------------------------|--------------|---------------|
| | 2007 | 2006 | June 30, 2007 |
| Cash and cash equivalents | \$ 220,000 | \$ 366,000 | \$ 403,000 |
| Working Capital ¹ | \$ 6,471,000 | \$ 6,043,000 | \$ 6,648,000 |
| Credit Line outstanding balance | \$ 0 | \$ 1,200,000 | \$ 300,000 |
| Tangible book value/common share ² | \$ 0.95 | \$ 0.83 | \$ 0.88 |
| Number of days of sales outstanding (DSO) in accounts receivable at end of quarter ³ | 45 | 66 | 61 |
| | Six Months Ended December 30, | | Year Ending |
| | 2007 | 2006 | June 30, 2007 |
| Net cash provided by operations | \$ 1,266,000 | \$ 204,000 | \$ 1,480,000 |

1 Working Capital = Ending Current Assets less Ending Current Liabilities.

2 Tangible book value/common share = (Total shareholders equity - Net intangible asset (patents) - Goodwill) / (basic outstanding shares).

3 DSO = Ending Net Accounts Receivable balance / (Previous Quarter Sales / 91).

Our working capital at December 31, 2007 increased to \$6.5 million compared to \$6.0 million at December 31, 2006 and was approximately the same as the \$6.6 million at June 30, 2007. Cash flow provided by operations was \$1,266,000 in the six months ended December 31, 2007 compared to \$205,000 for the six months ended December 31, 2006. Fiscal year 2008 cash was provided through continued profitability and improvements in accounts receivable levels and higher levels of accounts payable.

On November 1, 2007, our existing credit facility with Wells Fargo was replaced with an expanded facility with a total borrowing capacity of \$6,562,500. The credit line increases our borrowing availability from \$2,000,000 to \$4,000,000. Its terms require monthly interest payments at the prime rate of interest (7.25% at December 31, 2007); or LIBOR (4.6% at December 31, 2007) plus 1.75%, at our discretion, based on outstanding borrowings. The credit facility expires on November 1, 2009. An additional term commitment is available for borrowings through November 1, 2008 for amounts up to \$2,000,000. We can take advances against this commitment through November 1, 2008, at which time the outstanding borrowings against this commitment will be converted to a term loan, to be amortized and repaid over 60 months. Its terms require monthly interest payments at the prime rate of interest; or LIBOR plus 2.0%, at our discretion, based on outstanding borrowings. It is anticipated that the borrowings from the term commitment will be used for construction financing of tenant improvements for our new Irvine facility. The term loan that was entered into in January 2006 to finance the Astromec purchase remains in place. As of December 31, 2007, there was a principal balance of \$520,833 to be fully paid-off in January 2010, following the contracted amortization schedule. Its terms require monthly interest payments at the prime rate of interest; or LIBOR plus 2.0%, at our discretion, based

on outstanding borrowings, with no minimum interest charge. All assets of the Company except our Carson City land and building secure the outstanding borrowings from Wells Fargo. There was no outstanding balance under the terms of the credit line or term commitment facility as of December 31, 2007. The total eligible additional borrowing capacity at December 31, 2007 was \$6,000,000.

At December 31, 2007, we had cash and cash equivalents of \$220,000. We believe that our cash and cash equivalents on hand, together with cash flows from operations, if any, and amounts available under the credit facilities will be sufficient to meet our working capital and capital expenditure requirements for the next year.

In September 2002, our Board of Directors authorized the repurchase on the open market of up to 500,000 shares of our outstanding Common Stock at a share price no greater than \$1.25, subject to compliance with applicable laws and regulations. There is no requirement that we repurchase all or any portion of such shares. The maximum total value of the repurchase is not to exceed \$500,000. This repurchase is to be financed with cash generated by operations. From the inception of the repurchase authorization through the fiscal year-end date of June 30, 2003, we repurchased 75,700 shares of Common Stock for \$43,741, at an average price of \$0.58 per share. Although the authority to continue the repurchase shares continues, no additional shares were repurchased in fiscal years 2004 through 2007 or to date during fiscal year 2008.

RECENT ACCOUNTING PRONOUNCEMENTS

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, (FIN 48), an interpretation of FASB Statement No. 109, Accounting for Income Taxes, (FASB 109). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB 109. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The cumulative effect of applying FIN 48 is to be reported as an adjustment to the opening balance of retained earnings in the year of adoption. As a result of the implementation of FIN 48, the Company recorded a decrease of \$75,000 to retained earnings, an increase of \$47,000 to net deferred income tax assets and an increase of \$122,000 to income taxes payable as of July 1, 2007.

MAJOR CUSTOMERS

We had two major customers (defined as a customer that represents greater than 10% of the Company's total revenues) in the six months ended December 31, 2007 and 2006.

| | Six months ended December 31, (unaudited) | | | |
|------------|--|-------------|--------------|-------------|
| | 2007 | | 2006 | |
| | Revenues | Accts. Rec. | Revenues | Accts. Rec. |
| Customer 1 | \$ 2,569,000 | \$ 520,000 | \$ 1,776,000 | \$ 902,000 |

| | | | | | | | | |
|------------|----|-----------|----|---------|----|-----------|----|---------|
| Customer 2 | \$ | 3,083,000 | \$ | 701,000 | \$ | 2,033,000 | \$ | 388,000 |
|------------|----|-----------|----|---------|----|-----------|----|---------|

Item 3. Controls and Procedures

The Chief Executive Officer and Chief Financial Officer (the principal executive officer and principal financial officer, respectively) conducted an evaluation of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (Exchange Act)). Based on that evaluation for the quarter ended December 31, 2007, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures are effective to ensure that information required to be disclosed by use in the reports filed or submitted by us under the Exchange Act is accumulated, recorded, processed, summarized and reported to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, and to allow timely decisions regarding whether or not disclosure is required.

During the quarter ended December 31, 2007, there were no changes in our internal controls over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act) that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

PART II

OTHER INFORMATION

Item 1. Legal Proceedings

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

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

None.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Submissions of Matters to a Vote of Securities Holders.

On December 4, 2007, the Company held its 2007 Annual Shareholders Meeting. At the Meeting, the Company's shareholders (i) Amended the Company's Articles of Incorporation to remove the Class 1, Class II and Class III Board member designations; (ii) elected George Isaac, Michael Mesenbrink and William Healey as directors; and (iii) ratified the appointment of Moss Adams, LLP as the Company's independent auditors for the fiscal year ending June 30, 2008.

The proposal to approve the amendment the Company's Articles of Incorporation received the following votes: For 7,107,013; Against 211,664; and Abstain 11,999. Mr. Isaac received the following votes: For 7,083,998; and Withhold 246,679. Mr. Mesenbrink received the following votes: For 5,868,149; and Withhold 1,462,528. Mr. Healey received the following votes: For 7,088,110; and Withhold 242,567. The proposal to ratify the appointment of Moss Adams, LLP received the following votes: For 7,299,507; Against 17,752; and Abstain/Broker Non-Votes 13,417.

Item 5. Other Information.

None.

Item 6. Exhibits.

Exhibits:

10.1 1994 Second amended Stock Option Plan

10.2 Second amended and restated 2004 Stock Option Plan

10.3 Second amended and restated Directors Stock Option Plan

10.4 2004 amended and restated Directors Stock Option Plan

31.1 Certifications of Chief Executive Officer Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certifications of Chief Financial Officer Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32 Certification of the Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

