

PRO DEX INC
Form 10-K
September 13, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-K

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended June 30, 2018

OR

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

For the transition period from _____ to _____

Commission File Number: 000-14942

PRO-DEX, INC.

(Exact name of registrant as specified in its charter)

Colorado

(State or Other Jurisdiction of Incorporation or Organization)

84-1261240

(I.R.S. Employer Identification No.)

2361 McGaw Avenue, Irvine, CA

(Address of Principal Executive Offices)

92614

(Zip Code)

(949) 769-3200

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

| Title of each class | Name of each exchange on which registered |
|----------------------------|--|
| Common Stock, no par value | NASDAQ Capital Market |

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

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Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer

Accelerated filer

Non-accelerated filer(*Do not check if a smaller reporting company*)

Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

As of December 31, 2017, the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the closing sales price on the Nasdaq Capital Market was approximately \$17.8 million. For the purpose of this calculation shares owned by officers, directors and 10% stockholders known to the registrant have been deemed to be owned by affiliates. This calculation does not reflect a determination that persons are affiliates for any other purposes.

As of September 6, 2018, 4,341,202 shares of the registrant's no par value common stock were outstanding.

Documents incorporated by reference:

Part III of this report incorporates by reference certain information from the registrant's definitive proxy statement (the Proxy Statement) for its 2018 Annual Meeting of Shareholders. The Proxy Statement will be filed with the U.S.

Securities and Exchange Commission within 120 days after the end of the fiscal year to which this report relates.

PRO-DEX, INC.

FORM 10-K

FOR THE FISCAL YEAR ENDED JUNE 30, 2018

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PART I

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements within the meaning of federal securities laws. Forward-looking statements are not based on historical facts but instead reflect the Company's expectations, estimates or projections concerning future results or events. These statements generally can be identified by the use of forward-looking words or phrases such as believe, expect, anticipate, may, could, intend, intent, belief, estimate, project, will, should or similar words or phrases. These statements are not guarantees of performance and are inherently subject to known and unknown risks, uncertainties and assumptions that are difficult to predict and could cause actual results, performance or achievements to differ materially from those expressed or indicated by those statements. The Company cannot assure you that any of its expectations, estimates or projections will be achieved.

Forward-looking statements included in this report are only made as of the date of this report and the Company disclaims any obligation to publicly update any forward-looking statement to reflect subsequent events or circumstances.

Numerous factors could cause the Company's actual results and events to differ materially from those expressed or implied by forward-looking statements, including, without limitation: loss of a significant customer, entry of new and stronger competitors, capital availability, unexpected costs, compliance with contractual obligations, failure to capitalize upon access to new customers, marketplace delisting, the ramifications of industry consolidation of medical products manufacturers, dealers and distributors, managed health care, market acceptance and support of new products, cancellation of existing contracts, customer in house production of products previously designed by and/or acquired from the Company, maintaining favorable supplier relationships, the Company's ability to engage qualified human resources as needed, regulatory compliance, general economic conditions and other factors described under Item 1A (Risk Factors) of this report. This list of factors is illustrative, but by no means exhaustive. All forward-looking statements should be evaluated with the understanding of their inherent uncertainty.

ITEM 1.

BUSINESS

Company Overview

Pro-Dex, Inc. (Company , Pro-Dex , we , our , us) specializes in the design, development and manufacture of autoclavable, battery-powered and electric, multi-function surgical drivers and shavers used primarily in the orthopedic and maxocranial facial markets. We have patented adaptive torque-limiting software and proprietary sealing solutions which appeal to our customers, primarily medical device distributors. We also manufacture and sell rotary air motors to a wide range of industries.

Through May 2018, our Finline Molds (Finline) division, acquired in fiscal 2015, manufactured plastic injection molding for a variety of industries. We sold the assets and business operations of our Finline division and the assets related to that division have been reclassified as assets held for sale on our consolidated balance sheet as of June 30, 2017.

Through April 2017, we provided engineering consulting and placement services, as well as quality and regulatory consulting services through our Engineering Services Division (ESD). Although we continue to provide engineering, quality and regulatory consulting services to our customers, we have ceased placement services and accordingly have disbanded our ESD Division. The cessation of placement services did not have a material impact on our financial position or results of operations.

Through January 2017, our OMS Division designed and manufactured multi-axis motion control systems used in factory automation and scientific research markets. We sold substantially all of the assets and the business operations of our OMS division located in Beaverton, Oregon to our long time general manager of the division. This division has been classified as a discontinued operation in conformity with applicable accounting guidance. Accordingly, unless otherwise indicated, OMS 's results have been reported as discontinued operations and removed from all financial discussions of continuing operations. (See Note 3 to the Consolidated Financial Statements contained elsewhere in this report).

In fiscal 2015, we acquired Huber Precision (Huber), a business that made custom machined parts. We made the investment to garner a wider customer base, but the sales to the customers that were serviced by Huber dwindled over time, such that activities have become immaterial. As a result, the intangible assets relating to Huber were impaired during the first quarter of fiscal 2017.

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 certain 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 and company specific information at www.sec.gov/edgar/searchedgar/companysearch.html.

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

Description of Business

The majority of our revenue is derived from designing, developing and manufacturing surgical devices for the medical device industry. The proportion of total sales by type is as follows (in thousands, except percentages):

| | Years Ended June 30, | | | |
|-----------------------------|-----------------------------|------|---------------------|------|
| | 2018 | | 2017 | |
| | (In thousands) | | | |
| | % of Revenue | | % of Revenue | |
| Medical device and services | \$ 20,282 | 90% | \$ 18,584 | 85% |
| Industrial and scientific | 826 | 4% | 882 | 4% |
| Dental and component | 596 | 3% | 786 | 4% |
| Repairs | 394 | 2% | 302 | 1% |
| Other | 367 | 1% | 1,389 | 6% |
| Total Sales | \$ 22,465 | 100% | \$ 21,943 | 100% |

Our medical device products utilize proprietary designs developed by us primarily under exclusive development and supply agreements and are manufactured in our Irvine, California facility, as are our dental products. Our medical device products are sold primarily to original equipment manufacturers and our dental products are sold primarily to dental product distributors. In our San Dimas, California facility we manufactured plastic injection molds for a wide

variety of industries through May 2018, upon which time we sold the division and terminated our obligations under the lease for the San Dimas facility. The proportion of total sales by facility is as follows:

| | Years Ended June 30, | | | | | |
|-------------|-----------------------------|--------|------|---------------------|--------|------|
| | 2018 | | | 2017 | | |
| | (In thousands) | | | | | |
| | % of Revenue | | | % of Revenue | | |
| Irvine | \$ | 22,107 | 98% | \$ | 20,987 | 96% |
| San Dimas | | 358 | 2% | | 956 | 4% |
| Total Sales | \$ | 22,465 | 100% | \$ | 21,943 | 100% |

In fiscal 2018, our top 20 customers accounted for 97% of our sales compared to 94% in fiscal 2017. In fiscal 2018, we had one customer, included in medical device revenue above, that accounted for 56% of sales with our next largest customer accounting for 12% of sales. This compares to fiscal 2017, when we had one customer, included in medical device revenue above, that accounted for 50% of our revenue and no other single customer accounted for more than 10% of our revenue. In many cases, including our largest customers, disclosure of customer names is prohibited by confidentiality agreements with such entities. We have no plans to discontinue the sales relationships with our existing significant customers.

Our business today is almost entirely driven by sales of our medical devices. Many of our significant customers place purchase orders for specific products that were developed under various development and/or supply agreements. Our customers may request that we design and manufacture a custom surgical device or they may hire us as a contract manufacturer to manufacture a product of their own design. In either case, we have extensive experience with autoclavable, battery-powered and electric, multi-function surgical drivers and shavers. 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 continue to invest in machinery and equipment to increase our machining through-put.

Simultaneously, we are working to build top-line sales through active proposals of new medical device products with new and existing customers. Our patented adaptive torque-limiting software has been very well received in the CMF market and we have continued investment in this area with research and development focused on applying this technology to thoracic surgical applications. We invested significantly during fiscal 2018 on a thoracic driver utilizing adaptive torque-limiting software, and in early fiscal 2019, entered a development contract with a current significant customer to private-label this driver for their unique specifications. We anticipate sales to this existing customer will increase late in fiscal 2019 as we add this product to their existing CMF driver and ancillary products that we currently supply.

In April 2017, we invested in Monogram Orthopaedics Inc. (Monogram), a medical device start-up specializing in precision, patient-specific orthopedic implants. In conjunction with making the loan to Monogram, we were granted the exclusive right to develop, engineer, manufacture and supply certain products on behalf of Monogram. We impaired our entire \$800,000 investment during the fourth quarter of fiscal 2018 due to indications that Monogram had exhausted its cash and had been unable to obtain additional financing to enable continued research to commercialize their technology. While we do not expect to recover our investment, if Monogram successfully raises the funds needed to commercialize their technology, we expect to generate future revenue streams pursuant to our contractual development and supply rights with them.

The majority of the raw materials and components used to manufacture our products are purchased and are available from several sources, including through our own in-house machining capabilities. Portescap, K-V Engineering, and Fischer Connectors are examples of key suppliers. We have no exclusive arrangements with any of our suppliers, but in several instances only one supplier is used for certain high-value components. In most of such instances, secondary suppliers have been identified, although it is likely that any transition to a new or different supplier would result in a delay in the supply chain. We consider our relationships with our suppliers and manufacturers to be good. We do not intend to terminate any such relationship at this time, nor does management have knowledge that any supplier or manufacturer intends to terminate its relationship with us.

Our commitment to product design, manufacturing and quality systems are supported by our compliance with several regulatory agency requirements and standards. We hold a U.S. Food and Drug Administration (FDA) Establishment Registration and a State of California Device Manufacturing License (Department of Public Health Food and Drug Branch) with respect to our Irvine, California facility. In addition, our Irvine, California facility is certified to ISO

13485:2003, Medical Device Directive 93/42/EEC Annex II, and Canadian Medical Device Conformity Assessment System.

At June 30, 2018, we had a backlog of \$12.3 million compared with a backlog of \$8.7 million at June 30, 2017. Our backlog represents firm purchase orders received and acknowledged from our customers and does not include all revenue expected to be generated from existing customer contracts. Our entire backlog at June 30, 2018 is expected to be delivered during fiscal 2019. We have experienced, and may continue to experience, variability in our new order bookings due to, among other reasons, the launch of new products, the timing of customer orders based on end-user demand, and customer inventory levels. We do not typically experience seasonal fluctuations in our shipments and revenues.

Segments

With the sale of the OMS division during fiscal 2017, we no longer have separate reportable segments. The OMS division was historically the only division that was significant enough to require segment disclosures and as such, effective with this divestiture, we no longer require segment disclosure as our business is currently run.

Competition

The markets for products in the industries served by our customers are intensely competitive, and we face significant competition from a number of different sources. Several of our competitors have significantly greater name recognition, as well as substantially greater financial, technical, product development and marketing resources, than us.

We compete in all of our markets with other major medical device companies. As a provider of outsourced services, we also compete with our customers' own internal development and manufacturing groups. Competitive pressures and other factors, such as new product or new technology introductions by us, our customers' internal development and manufacturing departments, or our competitors, may result in price or market share erosion that could have a material adverse effect on our business, results of operations and financial condition. Also, there can be no assurance that our products and services will achieve broad market acceptance or will successfully compete with other products targeting the same customers.

Research and Development

We conduct research and development activities to both maintain and improve our market position. Our research and development effort involves the design and manufacture of products that perform specific applications for our existing and prospective customers. Our research and development activities are focused on:

- expanding our knowledge base in the medical device industry to solidify our products with current customers and expand our customer base;
- advancing applicable technologies; and
- enhancing our product lines.

In certain instances we may share research and development costs with our customers by billing for non-recurring engineering services. Revenue recognized for non-recurring engineering services represented 1% and 4% of our revenue in fiscal 2018 and 2017, respectively. During recent years, we have entered into certain development and supply contracts, the development portions of which provide for billable non-recurring engineering service fees. Such fees are recognized as revenue generally upon milestone completion or completion of the product development services. The revenue earned during fiscal 2018 relating to non-recurring engineering services was not material. During fiscal 2017, we completed the development of a surgical handpiece for a customer and began shipping products to this customer. Revenue for this development contract was recorded under the milestone completion method and we recognized revenue of \$752,000 and \$367,000 during fiscal 2017 and 2016, respectively. We will continue to pursue other revenue-generating development projects and in that regard we have two such development

contracts, one executed in late fiscal 2018 and one in early fiscal 2019, expected to generate approximately \$700,000 of non-recurring engineering services revenue during fiscal 2019. Accordingly, we believe that non-recurring engineering fees could represent a greater share of our revenue in the future, but there can be no assurance that we will be successful in these endeavors.

During the fiscal years ended June 30, 2018 and 2017, we incurred research and development expenses amounting to \$1.9 million and \$1.2 million, respectively, which costs exclude labor and related expenses of approximately \$46,000 and \$130,000 in fiscal 2018 and 2017, respectively, that were reimbursed by our customers through billings for non-recurring engineering services.

Employees

At June 30, 2018, we had 80 employees as well as 1 temporary employee all working at our corporate office in Irvine, California. Since we sold our Fineline division in May 2018, we have no employees in San Dimas, California at June 30, 2018. At June 30, 2017, we had 76 employees, comprised of 70 employees in Irvine, California and 6 in San Dimas, California, as well as 5 temporary employees working in Irvine, California. None of our employees are a party to any collective bargaining agreements with us. We consider our relationships with our employees to be good.

Government Regulations

The manufacture and distribution of medical and dental devices are subject to state and federal requirements set forth by various agencies, including the FDA, and state medical and dental boards. The statutes, regulations, administrative orders, and advisories that affect our businesses are complex and subject to diverse, often conflicting, interpretations. While we make every effort to maintain full compliance with all applicable laws and regulations, we are unable to eliminate the ongoing risk that one or more of our activities or devices may at some point be determined to be non-compliant. The penalties for non-compliance could range from an administrative warning to termination of a portion of our business. Furthermore, even if we are subsequently determined to have fully complied with applicable laws or regulations, the costs to achieve such a determination and the intervening loss of business could adversely affect or result in the cessation of a portion of our business. A change in such laws or regulations at any time may have an adverse effect on our operations.

The FDA designates all medical devices into one of three classes (Class I, II or III) based on the level of control necessary to assure the safety and effectiveness of the device (with Class I requiring the lowest level of control and Class III requiring the greatest level of control). The surgical instrumentation we manufacture is generally classified into Class I, and our dental instrumentation is generally classified into Class II. The FDA has broad enforcement powers to recall and prohibit the sale of products that do not comply with federal regulations, and to order the cessation of non-compliant processes. No claim has been made to date by the FDA regarding any of our products or processes. Nevertheless, as is common in the industry, certain of our products and processes have been the subject of routine governmental reviews and investigations.

The total cost of providing health care services has been and will continue to be subject to review by governmental agencies and legislative bodies in the major world markets, including the United States, which are faced with significant pressure to lower health care costs. The Patient Protection and Affordable Care Act signed into law in March 2010 (the Affordable Care Act) imposes a 2.3% excise tax, currently suspended until December 31, 2019, on sales of certain medical devices, some of which we produce, that we may be unable to recover through price increases to our customers.

We believe that our business is conducted in a manner consistent with the Environmental Protection Agency (EPA) and other agency regulations governing disposition of industrial waste materials.

While we believe that our products and processes fully comply with applicable laws and regulations, we are unable to predict the outcome of any investigation or review which may be undertaken in the future with respect to our products or processes.

Management believes that each of our facilities has manufacturing systems and processes that are based on established Quality Management System standards. In addition, we believe that our Irvine, California facility is compliant with applicable Good Manufacturing Practices promulgated by the FDA, and is compliant with applicable ISO standards set forth by the International Organization for Standardization.

Patents, Trademarks and Licensing Agreements

We hold patents relating to miniature rotary drive products and torque-limiting screwdrivers. Our patents have varying expiration dates. The near term expiration of the patents, if any, is not expected to cause any change in our revenue-generating operations as the revenue from the products associated with those patents is not material.

We have no reason to believe that our activities infringe upon the intellectual property of any third party. With respect to our own patents, we have no reason to believe that our patents are invalid and we believe that at least some of our patents cover certain aspects of our products. While we are unaware of any reason that would cause us to assert or defend a claim of patent infringement, any such assertion or defense could materially and adversely affect our business and results of operations due to the costs involved.

We have certain federally registered trademarks relating to our products, including Pro-Dex[®], along with a number of other common law trademarks.

We have not entered into any franchising agreements. We have not granted nor do we hold any third-party licenses having terms under which we earn revenue or incur expense in material amounts.

ITEM 1A.

RISK FACTORS

Investing in our common stock involves a high degree of risk. You should carefully consider the following risk factors, as well as the other information contained in this report, before deciding whether to invest in shares of our common stock. If any of the following risks actually occur, our business, financial condition, operating results and prospects would suffer. In that case, the trading price of our common stock would likely decline and you might lose all or part of your investment in our common stock. The risks described below are not the only ones we face. Additional risks that we currently do not know about or that we currently believe to be immaterial may also impair our operations and business results.

A substantial portion of our revenue is derived from a few customers. If we were to lose a key customer, it would have a material adverse effect on our business, financial condition and results of operations.

In fiscal 2018, our top 20 customers accounted for 97% of our sales, with our current largest customer accounting for 56% of our sales. This customer has made purchase commitments to us through a supply agreement to purchase surgical handpieces through calendar 2021. The loss of this customer or any of our significant customers would severely impact us, including having a material adverse effect on our business, financial condition, cash flows, revenue and results of operations.

A substantial portion of our business is derived from our core business area that, if not serviced properly, may result in a material adverse impact upon our business, results of operations and financial condition.

In fiscal 2018, we derived 90% of our revenue from sales of our medical device products and related services. We believe that a primary factor in the market acceptance of our products and services is the value they create for our customers. Our future financial performance will depend in large part on our ability to continue to meet the increasingly sophisticated needs of our customers through the timely development, successful introduction and implementation of new and enhanced products and services, while at the same time continuing to provide the value our customers have come to expect from us. We have historically expended a significant percentage of our revenue on product development and believe that significant continued product development efforts will be required to sustain our growth. Continued investment in our sales and marketing efforts will also be required to support future growth.

There can be no assurance that we will be successful in our product development efforts, that the market will continue to accept our existing products, or that new products or product enhancements will be developed and implemented in a

timely manner, meet the requirements of our customers, or achieve market acceptance. If the market does not continue to accept our existing products, or our new products or product enhancements do not achieve market acceptance, our business, results of operations and financial condition could be materially adversely affected.

Our customers may cancel or reduce their orders, change production quantities or delay production, any of which would reduce our sales and adversely affect our operating results.

Since most of our customers purchase our products from us on a purchase order basis, they may cancel, change, or delay product purchase commitments with little notice to us. As a result, we are not always able to forecast with certainty the sales that we will make in a given period and sometimes we may increase our inventory, working capital, and overhead in expectation of orders that may never be placed, or, if placed, may be delayed, reduced, or canceled.

The following factors, among others, affect our ability to forecast accurately our sales and production capacity:

- Changes in the specific products or quantities our customers order; and
- Long lead times and advance financial commitments for components required to complete actual/anticipated customer orders.

Delayed, reduced or canceled purchase orders also may result in our inability to recover costs that we incur in anticipation of those orders, such as costs associated with purchased raw materials and write-offs of obsolete inventory.

In recent years, we have launched many new medical device products and our estimates of warranty claims are based largely on our previous history from similar legacy products. If actual warranty claims exceed our estimates, it could have an adverse effect on our results of operations and financial condition.

We have recently completed significant medical device development projects in the craniomaxillofacial (CMF) surgical segment as well as a surgical handpiece used for orthopedic applications for which we have made estimates of product warranty claims based upon similar, legacy products. If the actual repair volumes or repair costs exceed the estimates that we have been using, we may incur additional costs which could be materially adverse to our results of operations and financial condition.

We face significant competition from a number of different sources, which could negatively impact our results of operations and business conditions.

The markets for products in the industries served by our customers are intensely competitive, and we face significant competition from a number of different sources. Several of our competitors have significantly greater name recognition, as well as substantially greater financial, technical, product development and marketing resources, than us.

We compete in all of our markets with other major surgical device and related companies. As a provider of outsourced products and services, we also compete with our customers' own internal development groups. Competitive pressures and other factors, such as new product or new technology introductions by us, our customers' internal development and manufacturing departments, or our competitors, may result in price or market share erosion that could have a material adverse effect on our business, results of operations and financial condition. Also, there can be no assurance that our products and services will achieve broad market acceptance or will successfully compete with other products.

The industry in which we operate is subject to significant technological change and any failure or delay in addressing such change could adversely affect our competitive position or could make our current products obsolete.

The medical device market is generally characterized by rapid technological change, changing customer needs, frequent new product introductions and evolving industry standards. The introduction of products incorporating new technologies and the emergence of new industry standards could render our existing products obsolete and unmarketable. There can be no assurance that we will be successful in developing and marketing new products that respond to technological changes or evolving industry standards.

New product development requires significant research and development expenditures that we have historically funded through operations; however, we may be unable to do so in the future. Any significant decrease in revenues or research funding could impair our ability to respond to technological advances in the marketplace and to remain competitive. If we are unable, for technological or other reasons, to develop and introduce new products in a timely manner in response to changing market conditions or customer requirements, our business, results of operations and financial condition may be materially adversely affected. Although we continue to target new markets for access, develop new products, and update existing products, there can be no assurance that we will do so successfully or that even if we are successful, such efforts will be completed concurrently with or prior to the introduction of competing products. Any such failure or delay could adversely affect our competitive position or could make our current products obsolete.

We rely heavily on our proprietary technology, which, if not properly protected or if deemed invalid, could have a material adverse effect on our business, results of operations and financial condition.

We are dependent on the maintenance and protection of our proprietary technology and rely on patent filings, exclusive development and supply agreements, confidentiality procedures and employee nondisclosure agreements to protect it. There can be no assurance that the legal protections and precautions taken by us will be adequate to prevent misappropriation of our technology or that competitors will not independently develop technologies equivalent or superior to ours. Further, the laws of some foreign countries do not protect our proprietary rights to as great an extent as do the laws of the United States and are often not enforced as vigorously as those in the United States.

We do not believe that our operations or products infringe on the intellectual property rights of others. However, there can be no assurance that others will not assert infringement or trade secret claims against us with respect to our current or future products. Assertions or claims by others, whether or not valid, could cause us to incur significant legal costs defending our intellectual property rights and potentially require us to enter into a license agreement or royalty arrangement with the party asserting the claim or to cease our use of the infringing technology, any of which could have a material adverse effect on our business, results of operations and financial condition.

Two of our directors hold voting power with respect to a substantial portion of our outstanding common stock that enables them to have significant influence over the outcome of all matters submitted to our shareholders for approval, which influence may conflict with our interests and the interests of other shareholders.

As of August 1, 2018, two of our directors, Nicholas J. Swenson and Raymond E. Cabillot, directly or indirectly, controlled voting power over approximately 39% (26% and 13%, respectively) of the outstanding shares of our common stock. As a result of such voting control, these directors will have significant influence over all matters submitted to our shareholders for approval, including the election of our directors and other corporate actions, and may have interests that conflict with our interests and the interests of other shareholders.

If our technology infrastructure is compromised, damaged or interrupted by a cybersecurity incident, data security breach or other security problems, our operating results and financial condition could be adversely affected.

We use technology in substantially all aspects of our business operations, and our ability to serve customers most effectively depends on the reliability of our technology systems. We use software and other technology systems, among other things, to generate sales orders, job orders and purchase orders and to monitor and manage our business on a day-to-day basis. Cybersecurity incidents can include computer viruses, computer denial-of-service attacks, worms, and other malicious software programs or other attacks, covert introduction of malware to computers and networks, impersonation of authorized users, and efforts to discover and exploit any design flaws, bugs, security vulnerabilities or security weaknesses, as well as intentional or unintentional acts by employees or other insiders with access privileges, intentional acts of vandalism by third parties and sabotage.

In addition, our technology infrastructure and systems are vulnerable to damage or interruption from natural disasters, power loss and telecommunications failures. Any such disruption to our systems, or the technology systems of third parties on which we rely, the failure of these systems to otherwise perform as anticipated, or the theft, destruction, loss, misappropriation, or release of sensitive and/or confidential information or intellectual property, could result in business disruption, negative publicity, loss of customers, potential liability, including litigation or other legal actions against us or the imposition of penalties, fines, fees or liabilities, which may not be covered by our insurance policies, and competitive disadvantage, any or all of which would potentially adversely affect our customer service, decrease the volume of our business and result in increased costs and lower profits. Moreover, a cybersecurity breach could require us to devote significant management resources to address the problems associated with the breach and to expend significant additional resources to upgrade further the security measures we employ to protect information against cyber-attacks and other wrongful attempts to access such information, which could result in a disruption of our operations.

While we have invested, and continue to invest, in technology security initiatives and other measures to prevent security breaches and cyber incidents, as well as disaster recovery plans, these initiatives and measures may not be entirely effective to insulate us from technology disruption that could result in adverse effects on our results of operations.

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

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

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

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

Our quarterly results can fluctuate significantly from quarter to quarter, which may negatively impact the price of our shares and/or cause significant variances in the prices at which our shares trade.

Our sales have fluctuated in the past, and may fluctuate in the future from quarter to quarter and period to period, as a result of a number of factors, including, without limitation: the size and timing of orders from customers; the length of new product development cycles; market acceptance of new technologies; changes in pricing policies or price reductions by us or our competitors; the timing of new product announcements and product introductions by us or our competitors; the financial stability of major customers; our success in expanding our sales and marketing programs; acceleration, deferral, or cancellation of customer orders and deliveries; changes in our strategy; revenue recognition policies in conformity with accounting principles generally accepted in the United States (GAAP); personnel changes; and general market and economic factors.

Because a significant percentage of our expenses are fixed, a variation in the timing of sales can cause significant fluctuations in operating results from quarter to quarter. As a result, we believe that interim period-to-period comparisons of our results of operations are not necessarily meaningful and should not be relied upon as indications of future performance. Further, our historical operating results are not necessarily indicative of future performance for any particular period.

In addition, it is possible that our operating results in future quarters may be below the expectations of public market analysts and investors. In such an event, the price of our common stock could be materially adversely affected.

Our operations are dependent upon our key personnel. If such personnel were to leave unexpectedly, we may not be able to execute our business plan.

Our future performance depends in significant part upon the continued service of our key technical and senior management personnel. Because we have a relatively small number of employees when compared to other companies in the same industry, our dependence on maintaining our relationship with key employees is particularly significant. We are also dependent on our ability to attract and retain high quality personnel, particularly in the areas of product development, operations management, marketing and finance.

A high level of employee mobility and the aggressive recruiting of skilled personnel characterize the medical device industry. There can be no assurance that our current employees will continue to work for us. Loss of services of key employees could have a material adverse effect on our business, results of operations and financial condition. Furthermore, we may need to provide enhanced forms of incentive compensation to attract and retain such key personnel.

Our operations are subject to a number of complex government regulations, the violation of which could have a material adverse effect on our business.

The manufacture and distribution of medical and dental devices are subject to state and federal requirements set forth by various government agencies including the FDA and EPA. The statutes, regulations, administrative orders, and advisories that affect our businesses are complex and subject to diverse, often conflicting, interpretations. While we make every effort to maintain full compliance with all applicable laws and regulations, we are unable to eliminate the ongoing risk that one or more of our activities may at some point be determined to be non-compliant. The penalties for non-compliance could range from an administrative warning to termination of a portion of our business. Furthermore, even if we are subsequently determined to have fully complied with applicable laws or regulations, the costs to achieve such a determination and the intervening loss of business could adversely affect or result in the cessation of a portion of our business. A change in such laws or regulations at any time may have an adverse effect on our operations.

The FDA designates all medical devices into one of three classes (Class I, II or III) based on the level of control necessary to assure the safety and effectiveness of the device (with Class I requiring the lowest level of control and Class III requiring the greatest level of control). The surgical instrumentation we manufacture is generally classified into Class I, and our dental instrumentation is generally classified into Class II. The FDA has broad enforcement powers to recall and prohibit the sale of products that do not comply with federal regulations, and to order the cessation of non-compliant processes. No claim has been made to date by the FDA regarding any of our products or processes. Nevertheless, as is common in the industry, certain of our products and processes are from time to time subject to routine governmental reviews and investigations. We are also subject to EPA regulations concerning the disposal of industrial waste.

While management believes that our products and processes fully comply with applicable laws and regulations, we are unable to predict the outcome of any such future review or investigation.

We face increased costs in the healthcare industry due to government reform.

Political, economic and regulatory influences are subjecting the healthcare industry to fundamental changes. The Affordable Care Act enacted sweeping reforms to the U.S. healthcare industry, including mandatory health insurance, reforms to Medicare and Medicaid, the creation of large insurance purchasing groups, new taxes on medical equipment manufacturers, currently suspended through 2019, that apply to certain of our products and other significant modifications to the healthcare delivery system.

The global economic environment may impact our business, operating results or financial condition.

Changes in the global economic environment have caused, and may cause in the future, a general tightening in the credit markets, lower levels of liquidity, increases in rates of default and bankruptcy, and extreme volatility in credit, equity and fixed income markets. These macroeconomic developments could negatively affect our business, operating results or financial condition should they cause, for example, current or potential customers to become unable to fund purchases of our products, in turn resulting in delays, decreases or cancellations of purchases of our products and services, or causing the customer to not pay us or to delay paying us for previously purchased products and services. In addition, financial institution failures may cause us to incur increased expenses or make it more difficult either to obtain financing for our operations, investing activities (including the financing of any future acquisitions), or financing activities. Additional economic risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially and adversely affect our business, financial condition or operating results.

We face risks and uncertainties associated with potential litigation by or against us, which could have a material adverse effect on our business, results of operations and financial condition.

We continually face the possibility of litigation as either a plaintiff or a defendant. It is not reasonably possible to estimate the awards or damages, or the range of awards or damages, if any, that we might incur in connection with such litigation.

Many of our products are complex and technologically advanced. Such products may, from time to time, be the subject of claims concerning product performance and construction, including warranty claims. While we are committed to correcting such problems as soon as possible, there is no assurance that solutions will be found on a timely basis, if at all, to satisfy customer demands or to avoid potential claims or litigation. Also, due to the location of our facilities, as well as the nature of our business activities, there is a risk that we could be subject to litigation related to environmental remediation claims. We maintain insurance to protect against claims associated with the manufacture and use of our products as well as environmental pollution, but there can be no assurance that our insurance coverage

will adequately cover any claim asserted against us.

The uncertainty associated with potential litigation may have an adverse impact on our business. In particular, litigation could impair our relationships with existing customers and our ability to obtain new customers. Defending or prosecuting litigation could result in significant legal costs and a diversion of management's time and attention away from business operations, either of which could have a material adverse effect on our business, results of operations and financial condition. There can be no assurance that litigation would not result in liability in excess of our insurance coverage, that our insurance will cover such claims or that appropriate insurance will continue to be available to us in the future at commercially reasonable rates.

We have experienced losses in the past, and we cannot be certain that we will sustain our current profitability; we may need additional capital in the future to fund our businesses, which we may not be able to obtain on acceptable terms.

We have experienced operating losses in the past. Although we were profitable in fiscal 2018, 2017 and 2016, we incurred pre-tax losses from continuing operations of \$446,000, \$755,000, and \$1,903,000 in fiscal 2015, 2014 and 2013, respectively. Our ability to achieve or sustain profitability is based on a number of factors, many of which are out of our control, including the material costs for our products and the demand for our products.

We currently anticipate that our available capital resources, including our existing cash and cash equivalents and accounts receivable balances will be sufficient to meet our expected working capital and capital expenditure requirements as our business is currently conducted for at least the next 12 months. We may also attempt to raise additional funds through public or private debt or equity financings, if such financings become available on acceptable terms. We cannot be certain that any additional financing we may need will be available on terms acceptable to us, or at all. If adequate funds are not available or are not available on acceptable terms, we may not be able to take advantage of opportunities, develop new products or otherwise respond to competitive pressures, and our operating results and financial condition could be adversely affected.

We are subject to changes in and interpretations of financial accounting matters that govern the measurement of our performance, compliance with which could be costly and time consuming.

We are subject to changes in and interpretations of financial accounting standards that govern the measurement of our performance. Based on our reading and interpretations of relevant pronouncements, guidance, or concepts issued by, among other authorities, the Financial Accounting Standards Board, the SEC and the American Institute of Certified Public Accountants, management believes our performance, including current sales contract terms and business arrangements, has been properly reported. However, there continue to be issued pronouncements, interpretations and guidance for applying the relevant standards to a wide range of contract terms and business arrangements that are prevalent in the industries in which we operate. Future interpretations or changes by the regulators of existing accounting standards or changes in our business practices may result in future changes in our accounting policies and practices that could have a material adverse effect on our business, financial condition, cash flows, revenue and results of operations.

Our evaluation of internal controls and remediation of potential problems is costly and time consuming and could expose weaknesses in financial reporting.

Section 404 of the Sarbanes-Oxley Act of 2002, as amended, requires management's assessment of the effectiveness of our internal control over financial reporting. This process is expensive and time consuming, and requires significant attention of management. Management can give no assurance that material weaknesses in internal controls will not be discovered. If a material weakness is discovered, corrective action may be time consuming and costly, and could further divert the attention of management. The disclosure of a material weakness, even if quickly remedied, could reduce the market's confidence in our financial statements and harm our stock price, especially if a restatement of financial statements for past periods is required.

ITEM 1B.

UNRESOLVED STAFF COMMENTS

None.

ITEM 2.

PROPERTIES

Our executive offices and Irvine manufacturing facility are located at 2361 McGaw Avenue, Irvine, California 92614. We lease the 28,000 square foot facility from an unrelated third party at a current base monthly lease rate of \$36,493 with 3% annual escalations through the expiration of the lease in September 2027. The building is a one-story stand-alone structure of concrete tilt-up construction, approximately 35 years old and in good condition.

Our former San Dimas office and manufacturing facility was located at 210 West Arrow Highway, Suites C & D, San Dimas, California 91773. The 3,680 square foot facility was leased from an unrelated third party, at a base monthly lease rate of \$2,870 through May 2018, which terminated in conjunction with the sale of our Fineline division. The suites were located in a one-story building in an approximately 35-year-old industrial office complex in fair condition.

Our Irvine facility is believed to be adequate for our expected needs. We believe each facility we leased during fiscal 2018, is in full compliance with applicable state, EPA and other agency environmental standards.

ITEM 3.

LEGAL PROCEEDINGS

See Note 10 of Notes to Consolidated Financial Statements contained elsewhere in this report.

ITEM 4.

MINE SAFETY DISCLOSURES

Not applicable.

PART II**ITEM 5.****MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES***Market Information*

Our common stock is quoted under the symbol PDEX on the automated quotation system of the Nasdaq Capital Market (NASDAQ). The following table sets forth for the quarters indicated the high and low sales prices of our common stock as reported by NASDAQ. The quotations reflect inter-dealer prices, without retail markup, markdown, or commissions, and may not necessarily represent actual transactions. On September 7, 2018, the last sale price of our common stock as reported by NASDAQ was \$9.95 per share.

| | | High | | Low |
|---------------------------|----|-------------|----|------------|
| Year ended June 30, 2018: | | | | |
| First Quarter | \$ | 7.77 | \$ | 5.90 |
| Second Quarter | | 7.75 | | 6.80 |
| Third Quarter | | 7.20 | | 6.35 |
| Fourth Quarter | | 7.00 | | 6.25 |
| Year ended June 30, 2017: | | | | |
| First Quarter | \$ | 6.53 | \$ | 4.41 |
| Second Quarter | | 5.26 | | 4.10 |
| Third Quarter | | 5.60 | | 4.55 |
| Fourth Quarter | | 6.15 | | 4.30 |

Holdings

As of September 7, 2018, there were 94 holders of record of our common stock. This number does not include beneficial owners including holders whose shares are held in nominee, or street, name.

Dividends

We have never paid a cash dividend with respect to our common stock. The current policy of our Board of Directors is to retain any future earnings to provide funds for the operation and expansion of our business. Any determinations to pay dividends in the future will be at the discretion of our Board of Directors.

Repurchases

During the fourth quarter of fiscal 2018, we repurchased 30,390 shares at an aggregate cost of \$202,000 through a Board approved prearranged share repurchase plan intended to qualify for the safe harbor under Rule 10b5-1 under the Securities Exchange Act of 1934, as amended. There were no repurchases during the fourth quarter of fiscal 2017.

Recent Sales

In February 2017, our Board approved an At The Market Offering Agreement (*ATM* or *ATM Agreement*) with Ascendant Capital Markets, LLC (*Ascendant*). The *ATM Agreement* allows us to sell shares of our common stock pursuant to specific parameters defined by us as well as those defined by the SEC and the *ATM Agreement*. During the fiscal quarter ended June 30, 2017, we sold 8,276 shares of common stock and raised proceeds of \$48,000, net of commissions and paid fees to Ascendant totaling \$1,500. During the fiscal year ended June 30, 2018, we sold 332,189 shares of common stock under the *ATM* at average prices of \$7.02 per share, resulting in proceeds to us of \$2.3 million, net of commissions and fees. The shares were sold pursuant to the Company's shelf registration statement on Form S-3, as amended (File No. 333-215032), which was declared effective on February 8, 2017 by the SEC.

ITEM 6.

SELECTED FINANCIAL DATA

Not applicable.

ITEM 7.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our financial condition and results of operations should be read in conjunction with our Consolidated Financial Statements and the Notes thereto contained elsewhere in this report, as well as the Risk Factors included in Item 1A of this report. The following discussion contains forward-looking statements. (See Cautionary Note Regarding Forward-Looking Statements included in Part 1 of this report.)

Overview

The following discussion and analysis provides information that management believes is relevant to an assessment and understanding of our results of operations and financial condition for the fiscal years ended June 30, 2018 and 2017. The income from discontinued operations included in our consolidated statement of operations relates to the sale of our OMS division, which we sold in January 2017.

The Company, headquartered in Irvine, California, specializes in the design, development and manufacture of autoclavable, battery-powered and electric, multi-function surgical drivers and shavers used primarily in the orthopedic, spine, and maxocranial facial markets. We also sell rotary air motors. Our products are found in hospitals, medical engineering labs, scientific research facilities and high-tech manufacturing operations around the world.

In addition to our principal operations described above, our Fineline division, located in San Dimas, California, manufactured plastic injection molds for a wide variety of industries until May 2018, when we sold the division. Through April 2017, we provided engineering consulting and placement services, as well as quality and regulatory consulting services through our ESD Division. Although we continue to provide engineering, quality and regulatory consulting services to our customers, we have ceased placement services and accordingly have disbanded our ESD Division. The cessation of placement services did not have a material impact on our financial position or results of operations.

Critical Accounting Policies

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

Revenue Recognition

Revenue on product sales is recognized upon shipment to the customer when risk of loss and title transfer to the customer and all other conditions required by GAAP, as promulgated by the Financial Accounting Standards Board (FASB) in Accounting Standards Codification (ASC) Section 605 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 not material; accordingly, we do not establish a reserve for product returns at the time of sale.

We will adopt the requirements of Accounting Standards Update ("ASU") 2014-09, *Revenue from Contracts with Customers*, in the first quarter of fiscal 2019. The new standard will be adopted in the first quarter of fiscal 2019 using the modified retrospective method of adoption, and we will recognize the cumulative effect of initially applying the new standard as an adjustment to opening retained earnings as of July 1, 2018. The standard is not expected to have a material impact on our consolidated financial statements, except for expanded disclosures related to revenue in order to comply with the new guidance.

Estimated Losses on Product Development Services

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

Owing to the complexity of many of the contracts we have undertaken, the cost estimation process requires significant judgment. It is based upon the knowledge and experience of our project managers, engineers, and finance professionals. Factors that are considered in estimating the cost of work to be completed and ultimate profitability of the fixed price product development portion of development and supply contracts include the nature and complexity of the work to be performed, availability and productivity of labor, the effect of change orders, the availability of materials, performance of subcontractors, and expected costs for specific regulatory approvals.

Warranties

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

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

Inventories

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

Accounts Receivable

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

Deferred Costs

Deferred costs reflect costs incurred related to non-recurring engineering services under the terms of the related development and supply contracts. These costs get recorded to cost of sales in the period that the revenue is recognized pursuant to the terms of the underlying contract with our customer.

Investments

Investments consist of marketable equity securities of publicly held companies. The investments were made to realize a reasonable return, although there is no assurance that positive returns will be realized. Investments are marked to market at each measurement date, with unrealized gains and losses, net of income taxes, presented as adjustments to accumulated other comprehensive income or loss.

Long-lived Assets

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

Equipment and leasehold improvements are recorded at historical cost and depreciation is provided using the straight-line method over the following periods:

| | |
|------------------------|--|
| Equipment | Three to ten years |
| Leasehold improvements | Shorter of the lease term or the asset's estimated useful life |

Goodwill & Intangibles

We recorded goodwill and a trade name in conjunction with the asset purchase of Fineline during fiscal 2015. We assess the potential impairment of goodwill and trade name on an annual basis, or more frequently if there are events or changes in circumstances that may indicate potential impairment. Other intangibles consist of legal fees incurred in connection with patent applications, covenant not to compete, and customer lists including backlog. The legal fees will be amortized over the estimated product life of the underlying product related to the associated patent. The covenant not to compete and customer list including backlog relate to assets acquired in conjunction with the purchase of Huber and Fineline and will be amortized over their estimated useful lives or, in the case of Fineline, retired in connection with our sale of those assets.

Notes Receivable

Notes receivable are stated at unpaid principal balance and are subject to impairment losses. Management considers a note impaired when either i) based upon current information or factors, it is probable that the principal and interest payments will not be collected, or converted to equity, according to the terms of the secured convertible promissory note or ii) the fair market of the underlying collateral securing the note is less than the book value of the note receivable.

Business Combinations

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

measurement period, which is one year from the acquisition date, we may record adjustments to the assets acquired and liabilities assumed, with the corresponding offset to goodwill. Upon the conclusion of the measurement period, any subsequent adjustments are recorded to earnings.

Income Taxes

We recognize deferred tax assets and liabilities for temporary differences between the financial reporting basis and the tax basis of our assets and liabilities, along with net operating loss and tax credit carryovers. Deferred tax assets at June 30, 2018 and 2017 consisted primarily of basis differences related to research and development tax credit utilization, intangible assets, accrued expenses and inventories.

Significant management judgment is required in determining our provision for income taxes and the recoverability of our deferred tax assets. Such determination is based on our historical taxable income, with consideration given to our estimates of future taxable income and the periods over which deferred tax assets will be recoverable. In evaluating our ability to recover our deferred tax assets, we consider all available positive and negative evidence, including reversals of deferred tax liabilities, projected future taxable income and results of recent operations. The assumptions about future taxable income require significant judgment and are consistent with the plans and estimates we are using to manage the underlying business. In evaluating the objective evidence that historical results provide, we consider three years of cumulative operating income (loss). During fiscal 2017, we released approximately \$3.3 million of the tax effected valuation allowance, as we determined that we were more likely than not to generate sufficient levels of profitability to realize substantially all of our deferred tax assets.

Results of Operations for the Fiscal Year Ended June 30, 2018 Compared to the Fiscal Year Ended June 30, 2017

The following tables set forth results from continuing operations for the fiscal years ended June 30, 2018 and 2017:

| | 2018 | | Years Ended June 30, | | 2017 | |
|---|-------------|-----------------------|-------------------------------|-------|-----------------------|--|
| | | | (Dollars in thousands) | | | |
| | | % of Net Sales | | | % of Net Sales | |
| Net sales | \$ 22,465 | 100% | \$ 21,943 | 100% | | |
| Cost of sales | 14,522 | 65% | 14,757 | 67% | | |
| Gross profit | 7,943 | 35% | 7,186 | 33% | | |
| Selling expenses | 358 | 2% | 585 | 3% | | |
| General and administrative expenses | 2,287 | 10% | 2,529 | 12% | | |
| Asset impairment charges | 1,029 | 5% | 113 | 1% | | |
| Gain from disposal of equipment | (16) | | (3) | | | |
| Research and development costs | 1,893 | 8% | 1,225 | 6% | | |
| | 5,551 | 25% | 4,449 | 20% | | |
| Operating income | 2,392 | 11% | 2,737 | 12% | | |
| Other income, net | 218 | 1% | 15 | | | |
| Income from continuing operations before income taxes | 2,610 | 12% | 2,752 | 13% | | |
| Income tax expense (benefit) | 989 | 5% | (2,089) | (10%) | | |
| Net income from continuing operations | \$ 1,621 | 7% | \$ 4,841 | 22% | | |

Net Sales

The majority of our revenue is derived from designing, developing and manufacturing powered surgical instruments for medical device original equipment manufacturers, dental instruments, and rotary air motors. The proportion of total sales by product/service type is as follows:

| | Years Ended June 30, | | Increase (Decrease) From 2017 To 2018 | | |
|-----------------------------|------------------------|----------------|--|------|-------|
| | 2018 | 2017 | | | |
| | (Dollars in thousands) | | | | |
| | % of Net Sales | % of Net Sales | | | |
| Net sales: | | | | | |
| Medical device and services | \$ 20,282 | 90% | \$ 18,584 | 85% | 9% |
| Industrial and scientific | 826 | 4% | 882 | 4% | (6%) |
| Dental and component | 596 | 3% | 786 | 4% | (24%) |
| Repairs | 394 | 2% | 302 | 1% | 30% |
| Other | 367 | 1% | 1,389 | 6% | (74%) |
| | \$ 22,465 | 100% | \$ 21,943 | 100% | 2% |

Net sales in fiscal 2018 increased by \$522,000, or 2%, as compared to fiscal 2017, due primarily to an increase in medical device sales of \$1.7 million offset by a decrease in dental and component revenue of \$190,000, and other revenue, consisting of the Fineline and ESD Divisions, of \$1.0 million. During fiscal 2018, sales to our largest customer increased by \$1.6 million to \$12.5 million, up from \$10.9 million in fiscal 2017. We manufacture a surgical handpiece designed to be used in orthopedic surgery applications for this customer and we have continued to see increased demand from this customer.

Sales of our industrial and scientific products, which consists primarily of our compact pneumatic air motors, decreased \$56,000 or 6 percent for fiscal 2018 compared to fiscal 2017. Our dental and component revenue is generated from sales to many distributors and end-users whose purchasing activity can vary widely from year to year. These are legacy products which have not had a product line refresh in several years. In January 2018, we sent notifications to our dental product customers that we are discontinuing the manufacture of these products and that same month we accepted final purchase orders to be fulfilled over the next six months. At this point we are focusing our product development and sales efforts almost exclusively on our medical device products, which prompted our decision to terminate the sales of our dental products. The cessation of our dental line of products is not expected to have a material impact on our financial position or results of operations.

Finally, our other revenue decreased \$1.0 million in fiscal 2018 compared to the prior fiscal year and includes revenue generated from our Finline and ESD Divisions of \$358,000 and \$10,000, respectively, in fiscal 2018, representing decreases of \$598,000 and \$427,000, respectively, compared to fiscal 2017. Due to declining sales of Finline, we sold the division in May 2018. Additionally and as indicated previously, in April 2017 we made a conscious decision to disband our ESD Division due to poor performance.

At June 30, 2018, we had a backlog of \$12.3 million compared with a backlog of \$8.7 million at June 30, 2017. Our backlog represents firm purchase orders received and acknowledged from our customers and does not include all revenue expected to be generated from existing customer contracts. Our entire backlog at June 30, 2018 is expected to be delivered during fiscal 2019. We have experienced, and may continue to experience, variability in our new order bookings due to, among other reasons, the launch of new products, the timing of customer orders based on end-user demand and customer inventory levels. We do not typically experience seasonal fluctuations in our shipments and revenues.

Cost of Sales and Gross Margin

| | Years Ended June 30, | | 2017 | Increase (Decrease) From 2017 To 2018 |
|--|------------------------|-------------------|-------------------|--|
| | 2018 | | | |
| | (Dollars in thousands) | | | |
| | | % of Net Sales | % of Net Sales | |
| Cost of sales: | | | | |
| Product costs | \$ 13,904 | 62% | \$ 14,597 | 67% |
| Accrued losses on product development services | 83 | | | 100% |
| Under (over)-absorption of manufacturing overhead | 322 | 2% | 115 | 180% |
| Inventory and warranty charges | 213 | 1% | 45 | 373% |
| Total cost of sales | \$ 14,522 | 65% | \$ 14,757 | 67% |

Cost of sales in fiscal 2018 decreased \$235,000, or 2%, from fiscal 2017, due to a \$693,000 decrease in product costs offset by an increase in under-absorption of manufacturing overhead of \$207,000, inventory and warranty charges of

\$168,000, and accrued losses on product development services of \$83,000. The decrease in product costs is due in large part to savings made by a full year of in-sourcing previously out-sourced manufactured parts. Our gross margin increased from 33 percent in fiscal 2017 to 35 percent in fiscal 2018, largely due to these savings. During fiscal 2018, we accrued \$83,000 for losses from the development services portion of certain contracts compared to none in fiscal 2017. Under-absorption of manufacturing costs increased by \$207,000 for fiscal 2018 compared to fiscal 2017, due primarily to adjustments to our standard labor and overhead rates at the beginning of fiscal 2018 in anticipation of higher manufacturing volumes. Costs related to inventory and warranty charges increased \$168,000 in fiscal 2018 compared to 2017, due primarily to \$154,000 in increased warranty expenses and an increase of \$14,000 in inventory charges.

Operating Expenses

| | Years Ended June 30, | | | Increase | |
|-------------------------------------|------------------------|------|----------|----------------|-----------|
| | 2018 | 2017 | | (Decrease) | From 2017 |
| | (Dollars in thousands) | | | To 2018 | |
| | % of Net Sales | | | % of Net Sales | |
| Operating expenses: | | | | | |
| Selling expenses | \$ 358 | 2% | \$ 585 | 3% | (39%) |
| General and administrative expenses | 2,287 | 10% | 2,529 | 11% | (10%) |
| Asset impairment charges | 1,029 | 5% | 113 | | 811% |
| Research and development costs | 1,893 | 8% | 1,225 | 6% | 55% |
| | \$ 5,567 | 25% | \$ 4,452 | 20% | 25% |

Selling expenses consist of salaries and other personnel-related expenses related to our business development departments, as well as trade show attendance, advertising and marketing expenses, and travel and related costs incurred in generating and maintaining customer relationships.

Selling Expenses by division
(in thousands except % of total)

| | Years Ended June 30, | | 2017 | Decrease From 2017 To 2018 |
|-------------------------------|----------------------|------------------------|------------|----------------------------------|
| | 2018 | (Dollars in thousands) | | |
| | | % of Total | % of Total | |
| Selling expenses: | | | | |
| Pro-Dex (Irvine) | \$ 202 | 56% | \$ 188 | 7% |
| ESD Division (Irvine) | | | 262 | (100%) |
| Fineline Division (San Dimas) | 156 | 44% | 135 | 16% |
| | \$ 358 | 100% | \$ 585 | (39%) |

Selling expenses for Pro-Dex Irvine during fiscal 2018 increased \$14,000, or 7%, compared to fiscal 2017, mostly due to increased commission expense. As previously discussed, we disbanded our ESD division during the fourth quarter of fiscal 2017 due to poor performance. Our Fineline division was sold in May 2018, and the increase in selling expenses in fiscal 2018 of \$21,000 is due to the broker commission recorded on the sale offset by one less month's typical expenses.

General and administrative expenses (G&A) consist of salaries and other personnel-related expenses for corporate, accounting, finance and human resource personnel, as well as costs for outsourced information technology services, professional fees, directors' fees and costs associated with being a public company. The \$242,000 decrease in G&A expenses from fiscal 2017 to 2018 is due primarily to reduced fiscal 2018 bonus accruals offset by increased stock compensation expense resulting from performance stock awards granted during fiscal 2018 (see Note 11 of the Consolidated Financial Statements contained elsewhere in this report).

The fiscal 2018 asset impairment charges relate to the impairment of our investment in Monogram in the amount of \$800,000 (see Note 8 of the Consolidated Financial Statements contained elsewhere in this report) as well as impairment of goodwill and intangible assets related to Fineline as a result of our impairment test (see Note 4 of Notes to Consolidated Financial Statements contained elsewhere in this report). The fiscal 2017 asset impairment charges relates to impairment of the Huber customer list.

Research and development costs consist of salaries and other personnel-related costs of our product development and engineering personnel, related professional and consulting fees, and costs related to intellectual property, laboratory usage, materials, and travel and related costs incurred in the development and support of our products. The increase in research and development costs of \$668,000 in fiscal 2018 as compared to fiscal 2017 relates primarily to the R&D efforts related to a new thoracic driver utilizing adaptive torque-limiting software.

Other Income (Expense)

Our other income primarily relates to \$199,000 of interest income earned related to our investment in a hotel through the Participation Agreement more fully described in Note 8 to the Consolidated Financial Statements contained elsewhere in this report.

Income Taxes

The effective tax rate for the year ended June 30, 2018 is nearer the statutory rates, which represent a blended rate for the rates in existence before and after the December 22, 2017 adoption of the Tax Cuts and Jobs Act. The effective tax rate for the fiscal year ended June 30, 2017 was significantly lower than the statutory rate primarily because we released a valuation allowance during the year in the amount of \$3.3 million. Management concluded that it was more likely than not that substantially all of our deferred tax assets will be realized, in part because in fiscal 2017 we achieved three years of cumulative pre-tax income and we had and continue to have forecasted future income.

The \$2.1 million of income tax benefit recorded to continuing operations for fiscal 2017 consists of the \$3.3 million benefit from the reduction of the valuation allowance, including \$2.4 million federal benefit and \$900,000 state benefit net of federal impact, offset by \$900,000 of federal and state income taxes on current year income from continuing operations and by approximately \$300,000 of tax expense for a reduction of state tax losses recorded in prior years.

Liquidity and Capital Resources

The following table is a summary of our Consolidated Statements of Cash Flows and Cash and Working Capital as of and for the fiscal years ended June 30, 2018 and 2017:

| | As of and for the Years | | | |
|---|-------------------------|---------|------|---------|
| | 2018 | | 2017 | |
| | Ended June 30, | | | |
| | (In thousands) | | | |
| Cash provided by (used in): | | | | |
| Operating activities | \$ | 3,096 | \$ | 3,235 |
| Investing activities | \$ | (4,115) | \$ | (1,026) |
| Financing activities | \$ | 2,002 | \$ | (298) |
| Cash, cash equivalents and working capital: | | | | |
| Cash and cash equivalents | \$ | 5,188 | \$ | 4,205 |
| Working capital | \$ | 13,695 | \$ | 9,703 |

Cash Flows from Operating Activities

Cash provided by operating activities during fiscal 2018 relates primarily to our net income of \$1.6 million and non-cash asset impairment charge of \$1.0 million, the non-cash decrease in deferred income taxes of \$391,000, and non-cash depreciation and amortization and stock compensation expense of \$557,000 and \$194,000, respectively, offset by an increase in inventory in the amount of \$1.3 million, due to projected increased demand from our largest customer. Offsetting the use of cash for inventory purchases, our accounts receivable decreased by \$569,000 and our income taxes payable increased by \$123,000.

Cash provided by operating activities during fiscal 2017 was \$3.2 million and relates primarily to our net income of \$5.1 million offset by the non-cash increase in the deferred income tax receivables of \$2.0 million due to the current year reversal of the valuation allowance. The changes in operating assets and liabilities net to a decrease of approximately \$125,000.

Cash Flows from Investing Activities

Net cash used in investing activities in fiscal 2018 was \$4.1 million and related to the \$1,150,000 Participation Agreement and the additional \$350,000 investment made in Monogram more fully described in Note 8 to the Consolidated Financial Statements contained elsewhere in this report. In addition, we invested \$923,000 in equipment and \$1.7 million in marketable equity securities during the fiscal year.

Net cash used in investing activities in fiscal 2017 was \$1.0 million. During the 2017 fiscal year, we invested \$663,000 in the purchase of marketable equity securities under the direction of the Investment Committee of our Board, made capital expenditures in the amount of \$606,000 primarily for manufacturing equipment and invested \$450,000 in Monogram as further described in Note 8 to the Consolidated Financial Statements contained elsewhere in this report. We also sold our OMS division in January 2017 for proceeds of \$636,000.

Cash Flows from Financing Activities

During fiscal 2018, we generated \$2.3 million in cash from financing activities through sales of our common stock under our ATM program more fully described in Note 14 to the Consolidated Financial Statements contained elsewhere in this report. We also spent \$220,000 on the repurchase of 33,026 shares of our common stock pursuant to the share repurchase program described in more detail below.

During fiscal 2017, we borrowed and repaid the principal amount of \$600,000 from Summit Financial Resources LP (Summit) and we spent \$312,000 on the repurchase of 63,496 shares of our common stock, pursuant to our share repurchase program.

Liquidity Requirements for the Next 12 Months

As of June 30, 2018, our working capital was \$13.7 million. We currently believe that our existing cash and cash equivalent balances, together with our account receivable balances, will provide us sufficient funds to satisfy our cash requirements as our business is currently conducted for at least the next 12 months. In addition to our cash and cash equivalent balances, we expect to derive a portion of our liquidity from our cash flows from operations. We may also borrow against our \$2.0 million Revolving Loan with Minnesota Bank & Trust (See Note 15 of Notes to Consolidated Financial statements contained elsewhere in this report).

We are focused on preserving our cash balances by monitoring expenses, identifying cost savings, and investing only in those development programs and products that we believe will most likely contribute to our profitability. As we execute our current strategy, however, we may require debt and/or equity capital to fund our working capital needs and requirements for capital equipment to support our manufacturing and inspection processes. In particular, we have experienced negative operating cash flow in the past, especially as we procure long-lead time materials to satisfy our backlog, which can be subject to extensive variability. We believe that if we need to raise additional capital to fund our operations, we can do so by selling additional shares of our common stock through our ATM.

Surplus Capital Investment Policy

During fiscal 2013, our Board approved a Surplus Capital Investment Policy (the Policy) that provides, among other items, for the following:

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

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

The Investment Committee approved each of the investments comprising the \$2.2 million of marketable public equity securities held at June 30, 2018, which amount includes unrealized holding losses in the amount of \$153,000 at June 30, 2018.

In September 2013, our Board approved a share repurchase program authorizing the Company to repurchase up to 750,000 shares of our common stock under parameters to be determined by the Investment Committee. In accordance with, and as part of, this share repurchase program, our Board has approved the adoption of several prearranged share repurchase plans intended to qualify for the safe harbor Rule 10b5-1 under the Securities Exchange Act of 1934, as amended (10b5-1 Plan or Plan). During the quarter ended September 30, 2016, our Board approved a 10b5-1 Plan, which became effective on September 8, 2016 and terminated on the earlier of September 8, 2017 or when and if the maximum shares were repurchased. During the quarter ended December 31, 2016, the Investment Committee of our Board approved an additional concurrently running 10b5-1 Plan, which became effective on December 8, 2016 and terminated on the earlier of December 8, 2017 or when and if the maximum shares were repurchased. In February 2017 our Board terminated the two effective 10b5-1 Plans in conjunction with the approval of the Company's ATM (described further in Note 14 of Notes to Consolidated Financial statements contained elsewhere in this report). During the fiscal year ended June 30, 2017, we repurchased 63,496 shares at an aggregate cost of \$312,000, inclusive of fees under the Plans.

On March 9, 2018, the Investment Committee of our Board approved a 10b5-1 Plan, which became effective on March 14, 2018 and terminates on the earlier of March 13, 2019 or when and if the maximum shares are repurchased. During the fiscal year ended June 30, 2018, we repurchased 33,026 shares at an aggregate cost, inclusive of fees under the plan of \$220,000. On a cumulative basis, we have repurchased a total of 265,983 shares under the share repurchase program at an aggregate cost of \$1.1 million. All repurchases under the 10b5-1 Plans were administered through an independent broker.

Recent Accounting Pronouncements

In May 2014, the 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. Application of the guidance in ASU 2014-09 is expected to require more judgment and estimates within the revenue recognition process compared to existing GAAP. We primarily sell finished products and recognize revenue at point of sale or delivery and this is not expected to change under the new standard. We also perform services when we are engaged to design a product for a customer. Typically, in those cases we have historically deferred revenue until project or milestone completion. Under the new standard we expect that revenue may be earned throughout the process using an over-time revenue recognition model. The new standard will be adopted in the first quarter of fiscal 2019 using the modified retrospective method of adoption, and we will recognize the cumulative effect of initially applying the new standard as an adjustment to opening retained earnings as of July 1, 2018. The standard is not expected to have a material impact on our consolidated financial statements, except for expanded disclosures related to revenue in order to comply with the new guidance.

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. However, the FASB issued ASU 2018-11 on July 30, 2018, which allows entities to apply the provisions of ASC 842 at the effective date without adjusting comparative periods. While we are still in the process of evaluating the effect of adoption on our consolidated financial statements and are currently assessing our leases, we expect the adoption will lead to a material increase in the assets and liabilities recorded on our consolidated balance sheet.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230), *Classification of Certain Cash Receipts and Cash Payments*. This update provides guidance on eight specific cash flow issues: (1) debt prepayment or debt extinguishment costs; (2) settlement of zero-coupon bonds; (3) contingent consideration payments made after a business combination; (4) proceeds from the settlement of insurance claims; (5) proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies; (6) distributions received from equity method investees; (7) beneficial interests in securitization transactions; and (8) separately identifiable cash flows and application of the predominance principle. The amendments in this update are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is permitted. We do not expect the application of this guidance to have a material impact on our consolidated financial statements.

In May 2017, the FASB issued Accounting Standards Update 2017-09, *Compensation-Stock Compensation (Topic 718): Scope of Modification Accounting* (ASU 2017-09). The update provides guidance as to which changes to the terms or conditions of a share-based payment award should be accounted for as a modification under Topic 718. Specifically, an entity would not apply modification accounting if the fair value, vesting conditions, and classification of an award as an equity or liability instrument are the same immediately before and after the modification. The standard is effective for the Company for annual periods beginning after December 15, 2017. Early adoption is permitted and prospective application is required. The Company does not expect the adoption of ASU 2017-09 to have a material effect on its consolidated financial statements.

ITEM 7A.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

ITEM 8.

FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

PRO-DEX, INC. AND SUBSIDIARIES

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Report of Independent Registered Public Accounting Firm

To the Shareholders and the Board of Directors of
Pro-Dex, Inc.

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of Pro-Dex, Inc. and Subsidiaries (the Company) as of June 30, 2018 and 2017, the related consolidated statements of operations and comprehensive income, shareholders equity and cash flows for each of the two years in the period ended June 30, 2018, and the related notes (collectively referred to as the consolidated financial statements). In our opinion, the consolidated financial statements present fairly, in all material respects, the consolidated financial position of the Company as of June 30, 2018 and 2017, and the consolidated results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Basis for Opinion

These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's consolidated financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (PCAOB) and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audits we are required to obtain an understanding of internal control over financial reporting but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.

Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures to respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ Moss Adams LLP
Moss Adams LLP
Irvine, California
September 13, 2018

We have served as the Company's auditor since 2003.

PRO-DEX, INC. AND SUBSIDIARIES**CONSOLIDATED BALANCE SHEETS****(In thousands, except share data)**

| | 2018 | June 30, | 2017 |
|---|-------------|-----------------|-------------|
| ASSETS | | | |
| Current assets: | | | |
| Cash and cash equivalents | \$ 5,188 | \$ | 4,205 |
| Investments | 2,220 | | 718 |
| Accounts receivable, net of allowance for doubtful accounts of \$14 and \$3 at June 30, 2018 and 2017, respectively | 2,955 | | 3,538 |
| Deferred costs | 32 | | 12 |
| Assets held for sale | | | 363 |
| Notes receivable (See Note 8) | 1,176 | | |
| Inventory | 4,393 | | 3,084 |
| Prepaid expenses and other current assets | 269 | | 363 |
| Total current assets | 16,233 | | 12,283 |
| Plant, equipment and leasehold improvements, net | 1,755 | | 1,350 |
| Intangibles, net | 140 | | 149 |
| Deferred income taxes, net | 1,678 | | 2,048 |
| Notes receivable, net of current portion (See Note 8) | 43 | | 450 |
| Other assets | 68 | | 71 |
| Total assets | \$ 19,917 | \$ | 16,351 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | | |
| Current liabilities: | | | |
| Accounts payable | \$ 1,083 | \$ | 1,159 |
| Accrued liabilities | 1,266 | | 1,344 |
| Deferred revenue | 31 | | 19 |
| Income taxes payable | 123 | | |
| Note payable | | | 26 |
| Capital lease obligations | 35 | | 32 |
| Total current liabilities | 2,538 | | 2,580 |
| Non-current liabilities: | | | |
| Deferred rent | 97 | | |
| Capital lease obligations, net of current portion | 6 | | 61 |
| Total non-current liabilities | 103 | | 61 |
| Total liabilities | 2,641 | | 2,641 |

Commitments and Contingencies:

Shareholders' equity:

Common stock, no par value, 50,000,000 shares authorized; 4,331,089 and 4,025,193 shares issued and outstanding at June 30, 2018 and

| | | | |
|---|-----------|----|---------|
| 2017, respectively | 19,835 | | 17,704 |
| Accumulated other comprehensive (loss) income | (153) | | 33 |
| Accumulated deficit | (2,406) | | (4,027) |
| Total shareholders' equity | 17,276 | | 13,710 |
| Total liabilities and shareholders' equity | \$ 19,917 | \$ | 16,351 |

See notes to consolidated financial statements.

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

| | Years Ended June 30, | |
|--|-----------------------------|-------------|
| | 2018 | 2017 |
| Net sales | \$ 22,465 | \$ 21,943 |
| Cost of sales | 14,522 | 14,757 |
| Gross profit | 7,943 | 7,186 |
| Operating (income) expenses: | | |
| Selling expenses | 358 | 585 |
| General and administrative expenses | 2,287 | 2,529 |
| Asset impairment charges | 1,029 | 113 |
| Gain on disposal of equipment | (16) | (3) |
| Research and development costs | 1,893 | 1,225 |
| Total operating expenses | 5,551 | 4,449 |
| Operating income | 2,392 | 2,737 |
| Other income (expense): | | |
| Interest and dividend income | 225 | 27 |
| Interest expense | (7) | (12) |
| Total other income | 218 | 15 |
| Income from continuing operations before income taxes | 2,610 | 2,752 |
| Income tax expense (benefit) | 989 | (2,089) |
| Net income from continuing operations | 1,621 | 4,841 |
| Income from discontinued operations, net of income taxes | | 243 |
| Net income | \$ 1,621 | \$ 5,084 |
| Other comprehensive income (loss), net of tax: | | |
| Unrealized gain (loss) from marketable equity investments, net of income taxes | (186) | 33 |
| Comprehensive income | \$ 1,435 | \$ 5,117 |
| Basic income per share: | | |
| Net income from continuing operations | \$ 0.38 | \$ 1.20 |
| Income from discontinued operations | | 0.06 |
| Net income | \$ 0.38 | \$ 1.26 |
| Diluted income per share: | | |
| Net income from continuing operations | \$ 0.37 | \$ 1.19 |
| Income from discontinued operations | | 0.06 |

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| | | | | |
|---|----|-----------|----|-----------|
| Net income | \$ | 0.37 | \$ | 1.25 |
| Weighted average common shares outstanding: | | | | |
| Basic | | 4,304,602 | | 4,040,308 |
| Diluted | | 4,344,765 | | 4,077,575 |

See notes to consolidated financial statements.

PRO-DEX, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

For The Years Ended June 30, 2018 and 2017

(In thousands, except share data)

| | Common Shares | | Accumulated Other Comprehensive Income (Loss) | | Accumulated Deficit | | Total |
|---|-----------------------------|---------------|--|-------|--------------------------------|----|--------------|
| | Number of Shares | Amount | | | | | |
| Balance at June 30, 2016 | 4,052,987 | \$ 17,988 | \$ | | \$ (9,111) | \$ | 8,877 |
| Net income | | | | | 5,084 | | 5,084 |
| Exercise of stock options ⁽¹⁾ | 23,632 | 7 | | | | | 7 |
| Net change in unrealized gain from marketable equity investments | | | | 33 | | | 33 |
| ESPP shares issued | 3,794 | 18 | | | | | 18 |
| Share-based compensation | | 3 | | | | | 3 |
| Shares issued under ATM ⁽²⁾ | 8,276 | | | | | | |
| Share repurchases | (63,496) | (312) | | | | | (312) |
| Balance at June 30, 2017 | 4,025,193 | \$ 17,704 | \$ | 33 | \$ (4,027) | \$ | 13,710 |
| Net income | | | | | 1,621 | | 1,621 |
| Net change in unrealized gain (loss) from marketable equity investments | | | | (186) | | | (186) |
| ESPP shares issued | 6,733 | 37 | | | | | 37 |
| | | 194 | | | | | 194 |

| | | | | | | | |
|--|-----------|----|--------|----|-------|------------|-----------|
| Share-based compensation | | | | | | | |
| Shares issued under ATM ⁽²⁾ | 332,189 | | 2,120 | | | 2,120 | |
| Share repurchases | (33,026) | | (220) | | | (220) | |
| Balance at June 30, 2018 | 4,331,089 | \$ | 19,835 | \$ | (153) | \$ (2,406) | \$ 17,276 |

- (1) During fiscal 2017, a total of 33,834 stock options were exercised and a total of 10,202 shares were used to effect a cashless exercise.
- (2) The proceeds raised from the ATM shares issued during fiscal 2017 in the net amount of \$48,000 were accounted for as a reduction of prepaid expenses related to establishing the ATM. Additionally, \$142,000 of proceeds raised from the ATM shares issued during fiscal 2018 were accounted for as a reduction of prepaid expenses.

See notes to consolidated financial statements.

PRO-DEX, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

| | Years Ended June 30, | |
|---|----------------------|----------|
| | 2018 | 2017 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 1,621 | \$ 5,084 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 557 | 555 |
| Gain on sale of OMS | | (327) |
| Gain on sale or disposal of equipment | (16) | (3) |
| Asset impairment charges | 1,029 | 113 |
| Share-based compensation | 194 | 3 |
| Deferred income taxes | 391 | (2,048) |
| Bad debt expense (recovery) | 14 | (17) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable, due from factor and other current receivables | 569 | (633) |
| Deferred costs | (19) | 226 |
| Assets held for sale | 31 | (22) |
| Inventory | (1,309) | 279 |
| Prepaid expenses and other assets | (45) | (299) |
| Accounts payable, accrued expenses and deferred rent | (57) | 518 |
| Deferred revenue | 13 | (193) |
| Income taxes payable | 123 | (1) |
| Net cash provided by operating activities | 3,096 | 3,235 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of equipment and leasehold improvements | (923) | (606) |
| Proceeds from sale of OMS | | 636 |
| Purchase of notes receivable (See Note 8) | (350) | (450) |
| Investment in Loan Participation (See Note 8) | (1,150) | |
| Proceeds from sale of investment in Ramsey | | 86 |
| Proceeds from sale of equipment | 30 | 3 |
| Increase in intangibles | (11) | (32) |
| Purchase of investments | (1,711) | (663) |
| Net cash used in investing activities | (4,115) | (1,026) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Principal payments on capital lease and note payable | (78) | (59) |
| Proceeds from shares issued under ATM | 2,262 | 48 |
| Borrowings from Summit loan | | 600 |

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| | | | |
|--|----------|----|-------|
| Repayments on Summit loan | | | (600) |
| Repurchases of common stock | (220) | | (312) |
| Proceeds from exercise of stock options and ESPP contributions | 38 | | 25 |
| Net cash provided by (used in) financing activities | 2,002 | | (298) |
| Net increase in cash and cash equivalents | 983 | | 1,911 |
| Cash and cash equivalents, beginning of year | 4,205 | | 2,294 |
| Cash and cash equivalents, end of year | \$ 5,188 | \$ | 4,205 |

See notes to consolidated financial statements.

PRO-DEX, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS - CONTINUED

(In thousands)

| | Years Ended June 30, | |
|--|----------------------|--------|
| | 2018 | 2017 |
| Supplemental disclosures of cash flow information: | | |
| Noncash investing and financing activities: | | |
| Promissory note issued in connection with sale of Fineline | \$ 280 | \$ |
| Capital lease for the acquisition of equipment | \$ | \$ 105 |
| Value of shares surrendered in connection with a stock option exercise | \$ | \$ 64 |
| Supplemental disclosures of cash flow information: | | |
| Cash paid for income taxes, net of refunds | \$ 401 | \$ 217 |
| Cash paid for interest | \$ 7 | \$ 12 |

See notes to consolidated financial statements.

PRO-DEX, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1.

DESCRIPTION OF BUSINESS

We specialize in the design, development and manufacture of autoclavable, battery-powered and electric, multi-function surgical drivers and shavers used primarily in the orthopedic and maxocranial facial markets. We have patented adaptive torque-limiting software and proprietary sealing solutions which appeal to our customers, primarily medical device distributors. We also manufacture and sell rotary air motors to a wide range of industries.

Our Fineline Molds division (Fineline), acquired in fiscal 2015, manufactured plastic injection molding for a variety of industries. As disclosed in a Form 8-K filed with the SEC on May 30, 2018, we sold substantially all of the assets of Fineline on May 23, 2018. The assets relating to Fineline have been reclassified as held for sale in the accompanying June 30, 2017 Consolidated Balance Sheet. Management reviewed ASU 2014-08 *Reporting Discontinued Operations and Disposals of Components of an Entity* and concluded that the sale of Fineline does not require treatment as a discontinued operation because it is was not a material part of our operations.

In fiscal 2015, we acquired Huber Precision (Huber), a business that made custom machined parts. We made the investment to garner a wider customer base, but the sales to the customers that were serviced by Huber dwindled over time, such that activities became immaterial. As a result, the intangibles relating to Huber were impaired during the first quarter of fiscal 2017.

Through January, 2017, we also designed and manufactured multi-axis motion control systems used in factory automation and scientific research markets and these products can be found in scientific research facilities and high tech manufacturing operations around the world. (See Note 3.)

Through April, 2017, we provided engineering consulting and placement services, as well as quality and regulatory consulting services through our Engineering Services Division (ESD). Although we continue to provide engineering, quality and regulatory consulting services to our customers, we have ceased placement services and accordingly have disbanded our ESD Division. The cessation of placement services did not have a material impact on our financial position or results of operations.

2.

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The summary of significant accounting policies presented below is designed to assist the reader in understanding our consolidated financial statements. Such financial statements and related notes are the representations of management, who is responsible for their integrity and objectivity. In the opinion of management, these accounting policies conform to accounting principles generally accepted in the United States of America (GAAP) in all material respects, and have been consistently applied in preparing the accompanying consolidated financial statements.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company. The wholly owned subsidiaries, Pro-Dex Sunfish Lake, LLC and Pro-Dex Riverside, LLC, both Delaware limited liability companies, were legally dissolved during fiscal 2018. There are no inter-company accounts or transactions.

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 *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.

PRO-DEX, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

We will adopt the requirements of Accounting Standards Update ("ASU") 2014-09, *Revenue from Contracts with Customers*, in the first quarter of fiscal 2019. The new standard will be adopted in the first quarter of fiscal 2019 using the modified retrospective method of adoption, and we will recognize the cumulative effect of initially applying the new standard as an adjustment to opening retained earnings as of July 1, 2018. The standard is not expected to have a material impact on our consolidated financial statements, except for expanded disclosures related to revenue in order to comply with the new guidance.

Estimated Losses on Product Development Services

Cost and revenue estimates related to the product development service portions of development and supply contracts are reviewed and updated quarterly. When it is probable that total costs from the development portion of such contracts will exceed product development service revenue, the expected loss is recognized immediately in cost of sales. Contract costs include all direct material, labor and those indirect costs related to contract performance.

Due to the complexity of many of the contracts we have undertaken, the cost estimation process requires significant judgment. It is based upon the knowledge and experience of our project managers, engineers, and finance professionals. Factors that are considered in estimating the cost of work to be completed and ultimate profitability of the fixed price product development portion of development and supply contracts include, among others, the nature and complexity of the work to be performed, availability and productivity of labor, the effect of change orders, the availability of materials, performance of subcontractors, and expected costs for specific regulatory approvals.

Warranties

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

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. 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.

Cash and Cash Equivalents

We consider all highly liquid investments with an original maturity of ninety days or less to be cash equivalents. At June 30, 2018 and 2017, cash equivalents consisted of investments in money market funds.

Accounts Receivable

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

Deferred Costs

Deferred costs reflect costs incurred related to non-recurring engineering services under the terms of the related development and supply contracts. These costs get recorded to cost of sales in the period that the revenue is recognized pursuant to the terms of the underlying contract with our customer.

PRO-DEX, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Inventories

Inventories are stated at the lower of cost (first-in, first-out method) or net realizable value. Cost includes materials, labor and manufacturing overhead related to the purchase and production of inventories. Reductions to estimated market value are recorded, and charged to cost of sales, when indicated based on a formula that compares on-hand quantities to both historical usage and estimated demand over the ensuing 12 months from the measurement date. On an on-going basis, we evaluate inventory for obsolescence and slow-moving items. This evaluation includes analysis of historical sales and usage, existing demand, as well as specific factors known to management. As of June 30, 2018, there was approximately \$301,000 of inventory in-transit.

Investments

Investments at June 30, 2018 and 2017 consist of marketable equity securities of publicly held companies. The investments were made to realize a reasonable return, although there is no assurance that positive returns will be realized. Investments are marked to market at each measurement date, with unrealized gains and losses, net of income taxes, presented as adjustments to accumulated other comprehensive income or loss.

Long-lived Assets

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

Equipment and leasehold improvements are recorded at historical cost and depreciation is provided using the straight-line method over the following periods:

| | |
|------------------------|--|
| Equipment | Three to ten years |
| Leasehold improvements | Shorter of the lease term or the asset's estimated useful life |

Goodwill & Intangibles

We recorded \$353,000 of goodwill and \$54,000 of trade name in conjunction with the asset purchase of Fineline during the fiscal year ended June 30, 2015. Accordingly, subsequent to the measurement period described below under Business Combinations, we assess potential impairment of goodwill and trade name annually, or more frequently if there are events or changes in circumstances that may indicate potential impairment. Intangibles consist of legal fees incurred in connection with patent applications, capitalized software development costs, covenant not to compete, trade name, and customer lists including backlog. Certain of the patent costs are being amortized over a period of seven years, the estimated life of the product that is currently utilizing the patented technology. The remaining patent costs will be amortized over the estimated life of the product(s) that will be utilizing the technology, or expensed immediately in the event the patent office denies the issuance of the patent. The covenant not to compete and customer list including backlog relate to assets acquired in conjunction with the purchase of Huber and Fineline and will be amortized over their estimated useful lives or, in the case of Fineline, retired in connection with our sale of those assets. The expense associated with the amortization of the covenants not to compete and customer list is recognized in selling expenses.

Business Combinations

We allocate the fair value of purchase consideration to the tangible assets acquired, liabilities assumed and intangible assets acquired based on their estimated fair values. The excess of the fair value of purchase consideration over the fair values of these identifiable assets and liabilities is recorded as goodwill. Such valuations require management to make significant estimates and assumptions, especially with respect to intangible assets. Significant estimates in valuing certain intangible assets include, but are not limited to, future expected cash flows, useful lives and discount rates. Management's estimates of fair value are based upon assumptions believed to be reasonable, but which are inherently uncertain and unpredictable and, as a result, actual results may differ from estimates. During the measurement period, which is one year from the acquisition date, we may record adjustments to the assets acquired and liabilities assumed, with the corresponding offset to goodwill. Upon the conclusion of the measurement period, any subsequent adjustments are recorded to earnings. There were no business acquisitions during fiscal 2018 and 2017.

PRO-DEX, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Notes Receivable

Notes receivable are stated at unpaid principal balance and are subject to impairment losses. Management considers a note impaired when either i) based upon current information or factors it is probable that the principal and interest payments will not be collected, or converted to equity, according to the terms of the secured convertible promissory note or ii) the fair market of the underlying collateral securing the note is less than the book value of the note receivable.

Income Taxes

We recognize deferred tax assets and liabilities for temporary differences between the financial reporting basis and the tax basis of our assets and liabilities along with net operating losses and tax credit carryovers. Deferred tax assets at both June 30, 2018 and 2017 consisted primarily of basis differences related to research and development tax credit utilization, accrued expenses, inventories and intangible assets.

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

Uncertain Tax Positions

We record uncertain tax positions in accordance with ASC 740 on the basis of a two-step process whereby (1) we determine whether it is more likely than not that the tax positions will be sustained on the basis of the technical merits of the position and (2) for those tax positions that meet the more-likely-than-not recognition threshold, we recognize the largest amount of tax benefit that is more than 50 percent likely to be realized upon ultimate settlement with the related tax authority.

Shipping and Handling

Payments from customers for shipping and handling are included in net sales. Shipping expenses, consisting primarily of payments made to freight companies, are included in cost of sales.

Concentration of Credit Risk

Financial instruments that potentially subject us to credit risk consist principally of cash, cash equivalents, and trade receivables. We place our cash and cash equivalents with major financial institutions. At June 30, 2018 and 2017, and throughout the fiscal years then ended, we had deposits in excess of federally insured limits. Credit sales are made to original equipment manufacturers and resellers throughout the world, and sales to such customers account for a substantial portion of our trade receivables. While such receivables are not collateralized, we evaluate their collectability based on several factors including customers' payment histories.

Compensation Plans

We recognize compensation expense for the share-based awards under ASC 718 *Compensation-Stock Compensation* by estimating their fair value using a Monte Carlo simulation. The fair value using a Monte Carlo simulation model is affected by assumptions regarding a number of complex judgments including expected stock price volatility, risk free interest rates, and the forecasted future value and trading volume of our stock. The awards are considered granted for accounting purposes on the date the awards were approved by the Compensation Committee and we recognize compensation expense, based on the estimated fair value of the award, on a straight-line basis over the requisite service period.

PRO-DEX, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Use of Estimates

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

Our operations are affected by numerous factors including market acceptance of our products, changes in technologies, and new laws, government regulations and policies. We cannot predict what impact, if any, the occurrence of these or other events might have on our operations. Significant estimates and assumptions made by management include, but are not limited to, revenue recognition, share-based compensation, the allowance for doubtful accounts, accrued warranty expense, inventory valuation, the carrying value of long-lived assets, the recoverability of notes receivable and the recovery of deferred income tax assets.

Basic and Diluted Per Share Information

Basic per share amounts are computed on the basis of the weighted-average number of common shares outstanding during each period presented. Diluted per share amounts assume the exercise of all potential common stock equivalents, consisting solely of options to purchase common stock as discussed in Note 11, unless the effect of such exercise is to increase income, or decrease loss, per common share.

Fair Value Measurements

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

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

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

Notes receivable: This investment is classified within Level 3 of the valuation hierarchy for purposes of evaluating potential impairment of these assets as of June 30, 2018. The fair value of the notes receivable was based upon the cost basis of the investment as well as our internal assessment of the value of the underlying collateral.

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

Advertising

Advertising costs are charged to selling or general and administrative expense as incurred and amounted to \$36,000 and \$3,000 for the fiscal years ended June 30, 2018 and 2017, respectively.

PRO-DEX, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Recent Accounting Standards

In May 2014, the 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. Application of the guidance in ASU 2014-09 is expected to require more judgment and estimates within the revenue recognition process compared to existing GAAP. We primarily sell finished products and recognize revenue at point of sale or delivery and this is not expected to change under the new standard. We also perform services when we are engaged to design a product for a customer. Typically, in those cases we have historically deferred revenue until project or milestone completion. Under the new standard we expect that revenue may be earned throughout the process using an over-time revenue recognition model. The new standard will be adopted in the first quarter of fiscal 2019 using the modified retrospective method of adoption, and we will recognize the cumulative effect of initially applying the new standard as an adjustment to opening retained earnings as of July 1, 2018. The standard is not expected to have a material impact on our consolidated financial statements, except for expanded disclosures related to revenue in order to comply with the new guidance.

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. However, the FASB issued ASU 2018-11 on July 30, 2018, which allows entities to apply the provisions of ASC 842 at the effective date without adjusting comparative periods. While we are still in the process of evaluating the effect of adoption on our consolidated financial statements and are currently assessing our leases, we expect the adoption will lead to a material increase in the assets and liabilities recorded on our consolidated balance sheet.

In August 2016, the FASB issued ASU 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments*. This update provides guidance on eight specific cash flow issues: (1) debt prepayment or debt extinguishment costs; (2) settlement of zero-coupon bonds; (3) contingent consideration payments made after a business combination; (4) proceeds from the settlement of insurance claims; (5) proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies; (6) distributions received from equity method investees; (7) beneficial interests in securitization transactions; and (8) separately identifiable cash flows and application of the predominance principle. The amendments in this update are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is permitted. We do not

expect the application of this guidance to have a material impact on our consolidated financial statements.

In May 2017, the FASB issued Accounting Standards Update 2017-09, *Compensation-Stock Compensation (Topic 718): Scope of Modification Accounting* (ASU 2017-09). The update provides guidance as to which changes to the terms or conditions of a share-based payment award should be accounted for as a modification under Topic 718. Specifically, an entity would not apply modification accounting if the fair value, vesting conditions, and classification of an award as an equity or liability instrument are the same immediately before and after the modification. The standard is effective for annual periods beginning after December 15, 2017. Early adoption is permitted and prospective application is required. We do not expect the adoption of ASU 2017-09 to have a material effect on our consolidated financial statements.

Recently Adopted Accounting Standards

In July 2015, the FASB issued ASU 2015-11, *Inventory (Topic 330): Simplifying the Measurement of Inventory*, which states that inventory should be measured at the lower of cost or net realizable value. Net realizable value is defined as estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation. We adopted the provisions of ASU 2015-11 effective July 1, 2017, applied prospectively. The adoption has not had a material impact on our condensed consolidated financial statements.

PRO-DEX, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In January 2017, the FASB issued its final standard on simplifying the test for goodwill impairment. This standard, issued as ASU 2017-04, eliminates step 2 from the goodwill impairment test and instead requires an entity to perform its annual or interim goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An impairment charge would be recognized for the amount by which the carrying amount exceeds the reporting unit's fair value. This update is effective for annual or interim goodwill impairment tests in fiscal years beginning after December 15, 2019, with early adoption permitted. We adopted this guidance during the second quarter of fiscal 2018, in conjunction with the performance of our goodwill impairment test.

Reclassifications

As described in more detail in Note 1 above, the assets relating to our Finline division have been reclassified as assets held for sale in accordance with applicable accounting guidance. These balance sheet reclassifications had no impact on our consolidated statement of operations.

We have reclassified the gain on disposal of equipment to operating income (expense) as prescribed by GAAP. This reclassification has no impact on our net income.

We have changed the allowance for doubtful accounts adjustment to reconcile net income to net cash provided by operating activities to bad debt expense (recovery) as prescribed by GAAP. This reclassification has no impact on net cash provided by or used in operating activities.

3.

DISCONTINUED OPERATIONS

On January 27, 2017, we sold substantially all of the assets and the business operations of our OMS division located in Beaverton Oregon. We sold the business to our long time general manager of the division. The sale was structured as an asset sale as disclosed in a Form 8-K filed with the SEC on January 30, 2017. The aggregate sales price received was \$636,000, and no liabilities other than warranty obligations were assumed by the buyer. As a result of the sale, this division has been classified as a discontinued operation in conformity with applicable accounting guidance. Accordingly, unless otherwise indicated, OMS's results have been reported as discontinued operations and removed

from all financial discussions of continuing operations.

The divestiture was completed in support of raising capital to invest in our core medical device product development efforts.

Operating results of the OMS division are as follows (in thousands):

| | Year ended June 30, 2017 | |
|---|---|------|
| Revenues | \$ | 715 |
| Income from discontinued operations: | | |
| Gain on sale, net of taxes of \$126,000 | \$ | 201 |
| Income from discontinued operations, before taxes | | 68 |
| Income expense | | (26) |
| Net income from discontinued operations | \$ | 243 |

Income from discontinued operations consists of direct revenues and direct expenses of the OMS business, including cost of revenues, as well as other fixed costs to the extent that such costs will be eliminated as a result of the sale. The Company historically did not allocate corporate overhead to this division. Additionally, the OMS division has historically been the only division that was significant enough to require segment disclosures and as such, effective with this divestiture, we no longer require segment disclosure as our business is currently run.

PRO-DEX, INC. AND SUBSIDIARIES**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****4.****GOODWILL AND INTANGIBLE ASSETS OF FINELINE**

Goodwill represents the excess of the purchase price over the fair value of identifiable net assets from the Fineline acquisition. 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 amounts included in the table below were included in assets held for sale on the June 30, 2017 Consolidated Balance Sheet. We account 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 have historically performed our annual impairment test as of January 31st of each year. However, we performed an impairment analysis as of December 31, 2017 because of declining Fineline revenue as well as the lapse of many outstanding Fineline proposals/bids, which indicated to us that the fair value of the Fineline reporting unit may be below its carrying value.

The following table presents the changes in the carrying amount of the Fineline goodwill, customer list, covenant not to compete and trade name (in thousands):

| | | Goodwill | Customer List | Covenant not to Compete | Trade Name |
|--|----|-----------------|----------------------|--------------------------------|-------------------|
| Balance at June 30, 2016 | \$ | 112 | \$ 133 | \$ 16 | \$ 50 |
| Amortization | | | (24) | (5) | |
| Balance at June 30, 2017 | \$ | 112 | \$ 109 | \$ 11 | \$ 50 |
| Amortization | | | (12) | (3) | |
| Impairment charge | | (112) | (97) | | (20) |
| Amount sold in conjunction with the sale of Fineline | | | |) | (30) |
| Balance at June 30, 2018 | \$ | | \$ | \$ | \$ |

The valuation methods utilized to value the long-lived assets and the goodwill discussed above are based on both a market approach and an income approach. The market approach relies on guideline public company and transaction methods which incorporates revenue and earnings multiples from publicly traded companies with operations and other characteristics similar to Fineline. The selected multiples consider Fineline's relative size and risks relative to the selected publicly traded companies. The income approach incorporates a discounted cash flow analysis 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.

5.

COMPOSITION OF CERTAIN FINANCIAL STATEMENT ITEMS

Investments

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

| | June 30, | |
|------------------------------|-----------------|-------------|
| | 2018 | 2017 |
| Marketable equity securities | \$ 2,220 | \$ 718 |

At June 30, 2018, our investments had an aggregate cost basis of \$2,373,000 and net unrealized losses of \$153,000 (gross unrealized losses of \$196,000 offset by gross unrealized gains of \$43,000).

PRO-DEX, INC. AND SUBSIDIARIES**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

At June 30, 2017, our investments had an aggregate cost basis of \$663,000 and net unrealized gains of \$55,000 (gross unrealized gains of \$57,000 offset by gross unrealized losses of \$2,000) and related tax expense of approximately \$22,000 recorded in other comprehensive income.

Of the total marketable equity securities at June 30, 2018 and 2017, \$285,000 and \$65,000, respectively, represent an investment in the common stock of Air T, Inc. Two of our Board members are also board members of Air T, Inc. and both either individually or through affiliates own an equity interest in Air T, Inc. Our Chairman, one of the two Board members aforementioned, also serves as the Chief Executive Officer and Chairman of Air T, Inc. The shares have been purchased through 10b5-1 Plans, which in accordance with our internal policies regarding the approval of related party transactions, was approved by our three Board members that are not affiliated with Air T, Inc.

Inventory

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

| | | June 30, | | |
|-------------------------------------|----|-----------------|----|-------------|
| | | 2018 | | 2017 |
| Raw materials /purchased components | \$ | 1,878 | \$ | 1,127 |
| Work in process | | 974 | | 746 |
| Sub-assemblies /finished components | | 1,193 | | 1,018 |
| Finished goods | | 348 | | 193 |
| Total inventory | \$ | 4,393 | \$ | 3,084 |

Equipment and Leasehold Improvements

Equipment and leasehold improvements consist of the following (in thousands):

| | | June 30, | | |
|--|--|-----------------|--|-------------|
| | | 2018 | | 2017 |

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| | | | | |
|---|----|---------|----|---------|
| Office furnishings and fixtures | \$ | 1,821 | \$ | 1,808 |
| Machinery and equipment | | 4,488 | | 5,140 |
| Leasehold improvements | | 2,170 | | 2,119 |
| Total | | 8,479 | | 9,067 |
| Less: Accumulated depreciation and amortization | | (6,724) | | (7,717) |
| | \$ | 1,755 | \$ | 1,350 |

Depreciation expense for the years ended June 30, 2018 and 2017 amounted to \$522,000 and \$505,000, respectively. During fiscal 2018, assets in the amount of approximately \$1.2 million were retired and an additional \$359,000 of fully depreciated assets were sold. In conjunction with the sale of the Fineline division during fiscal 2018, assets with a cost basis of \$160,000 and accumulated amortization totaling \$81,000 have been eliminated from the June 30, 2017 balances above, consistent with the assets held for sale presentation previously described.

Intangibles

Intangibles consist of the following (in thousands):

| | | June 30, | | |
|-------------------------------|----|----------|----|------|
| | | 2018 | | 2017 |
| Covenant not to compete | \$ | 30 | \$ | 30 |
| Patent-related costs | | 164 | | 153 |
| Total intangibles | | 194 | | 183 |
| Less accumulated amortization | | (54) | | (34) |
| | \$ | 140 | \$ | 149 |

PRO-DEX, INC. AND SUBSIDIARIES**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Amortization expense for both years ended June 30, 2018 and 2017 amounted to \$20,000.

The covenant not to compete relates to assets acquired in conjunction with the Huber business acquisition. Patent-related costs consist of legal fees incurred in connection with both patent applications and a patent issuance, and will be amortized over the estimated life of the product(s) that is or will be utilizing the technology, or expensed immediately in the event the patent office denies the issuance of the patent. Since we do not know when, or if, our patent applications will be issued, the future amortization expense is not predictable.

Accrued Liabilities

Accrued liabilities consist of the following (in thousands):

| | | June 30, | | |
|---|-------------|-----------------|-------------|-------|
| | 2018 | | 2017 | |
| Payroll and related items | \$ | 438 | \$ | 417 |
| Accrued inventory in transit | | 301 | | 52 |
| Accrued legal and professional fees | | 155 | | 151 |
| Accrued bonuses | | 109 | | 390 |
| Warranty | | 107 | | 159 |
| Accrued losses on development contracts | | 83 | | |
| Accrued sales, use and excise taxes | | 6 | | 9 |
| Deferred rent | | | | 68 |
| Other | | 67 | | 98 |
| | \$ | 1,266 | \$ | 1,344 |

6.**WARRANTY ACCRUAL**

Information relating to the accrual for warranty costs for the years ended June 30, 2018 and 2017 is as follows (in thousands):

| | | June 30, | | |
|--|----|-----------------|----|-------------|
| | | 2018 | | 2017 |
| Balance at beginning of year | \$ | 159 | \$ | 365 |
| Accruals during the year | | 102 | | 316 |
| Change in estimates of prior period accruals | | (97) | | (224) |
| Warranty amortization | | (57) | | (298) |
| Balance at end of year | \$ | 107 | \$ | 159 |

Warranty expense relating to new product sales and changes to estimates was \$5,000 and \$92,000, respectively, for the fiscal years ended June 30, 2018 and 2017.

PRO-DEX, INC. AND SUBSIDIARIES**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

7.

INCOME TAXES

On December 22, 2017, the Tax Cuts and Jobs Act (the "Tax Act") was enacted into law. The new legislation represents a fundamental and dramatic shift in US taxation. The new legislation contains several key tax provisions that will impact us including the reduction of the corporate income tax rate to 21% effective January 1, 2018. The new legislation also included a variety of other changes including but not limited to a limitation on the deductibility of interest expense, acceleration of business asset expensing and reduction in the amount of executive pay that could qualify as a tax deduction. The provision (benefit) for income taxes from continuing operations consists of the following amounts (in thousands):

| | Years Ended June 30, | |
|------------------------------|-----------------------------|-------------|
| | 2018 | 2017 |
| Current: | | |
| Federal | \$ 579 | \$ 34 |
| State | 19 | 40 |
| Deferred: | | |
| Federal | 247 | (1,263) |
| State | 144 | (900) |
| Income tax expense (benefit) | \$ 989 | \$ (2,089) |

Section 15 of the Internal Revenue Code stipulates that our fiscal year ended June 30, 2018 will have a blended federal statutory tax rate of 27.55%, which is based on the applicable tax rates before and after the effectiveness of the Tax Act and the number of days in the year. The effective income tax rate from income (loss) from continuing operations differs from the United States statutory income tax rates for the reasons set forth in the table below (in thousands, except percentages).

| | Years Ended June 30, | | | |
|--|-----------------------------|-----------------------|---------------|-----------------------|
| | 2018 | Percent Pretax | 2017 | Percent Pretax |
| | Amount | Income | Amount | Income |
| Income (loss) from continuing operations before income taxes | \$ 2,610 | 100% | \$ 2,752 | 100% |

| | | | | | | |
|---|----|------|------|----|---------|--------|
| Computed expected income tax expense (benefit) on income (loss) from continuing operations before income taxes | \$ | 719 | 28% | \$ | 936 | 34% |
| State tax, net of federal benefit | | 73 | 3% | | 270 | 10% |
| Tax incentives | | (47) | (2%) | | (36) | (1%) |
| Change in valuation allowance | | 202 | 8% | | (3,252) | (118%) |
| Tax law changes | | 119 | 5% | | | |
| Domestic production deduction | | (84) | (4%) | | | |
| Other | | 7 | | | (7) | (1%) |
| Income tax expense (benefit) | \$ | 989 | 38% | \$ | (2,089) | (76%) |

On December 22, 2017, the SEC issued Staff Accounting Bulletin No. 118 (SAB 118) which addresses income tax accounting implications of the Tax Act. The purpose of the SAB 118 was to address any uncertainty or diversity of view in applying ASC Topic 740, *Income Taxes*, in the reporting period in which the Tax Act was enacted. SAB 118 provides a measurement period that should not extend beyond one year from the Tax Act enactment date for companies to complete the accounting under ASC 740. Due to the timing of the enactment and the complexity involved in applying the provisions of the Tax Act, we have made reasonable estimates of the effects and recorded provisional amount in our financial statements as of June 30, 2018. We expect that the completion of our accounting analysis will not have a material impact in our deferred tax assets and liabilities or our effective tax rate.

PRO-DEX, INC. AND SUBSIDIARIES**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Deferred income taxes reflect the net effects of loss and credit carryforwards and temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of our deferred tax assets and liabilities for federal and state income taxes are as follows (in thousands):

| | 2018 | June 30, | 2017 |
|---|-------------|-----------------|-------------|
| Deferred tax assets: | | | |
| Federal & State NOL carryforward | \$ 23 | \$ | 181 |
| Research & other credits | 1,517 | | 1,832 |
| Reserves and accruals | 438 | | 180 |
| Stock based compensation | 55 | | |
| Inventory | 371 | | 446 |
| Other intangibles | 70 | | 178 |
| Goodwill | | | 77 |
| Other | 48 | | 1 |
| Total gross deferred tax assets | \$ 2,522 | \$ | 2,895 |
| Less: valuation allowance | (368) | | (89) |
| Total deferred tax assets | 2,154 | | 2,806 |
| | | | |
| | | June 30, | |
| | | 2018 | 2017 |
| Deferred tax liabilities: | | | |
| Property and equipment, principally due to differing depreciation methods | | \$ (318) | \$ (438) |
| Deferred state tax | | (152) | (295) |
| Other intangibles | | | (2) |
| Other | | (6) | (23) |
| Total gross deferred tax liabilities | | (476) | (758) |
| Net deferred tax assets | | \$ 1,678 | \$ 2,048 |

Realization of our deferred tax assets is dependent upon future earnings, if any, the timing and amount of which are uncertain. As of June 30, 2018, our deferred tax asset valuation allowance primarily consists of unrealized capital loss for investments held and the state net operating loss carryforwards for states in which we have filed a final return. For the year ended June 30, 2018, the Company recorded a net valuation allowance of \$279,000, on the basis of management's reassessment of the amount of its deferred tax assets that are more likely than not to be realized.

As of June 30, 2018, we did not have any net operating losses for federal and state income tax purposes for state jurisdictions in which we currently operate. We have federal research and development and alternative minimum tax credit carry forwards at June 30, 2018 of approximately \$877,000, which begin to expire in 2027. State tax research credit carry forwards at June 30, 2018 amount to \$640,000, the majority of which do not expire.

As of June 30, 2018, we have accrued \$462,000 of unrecognized tax benefits related to federal and state income tax matters that would reduce our income tax expense if recognized. If we are eventually able to recognize our uncertain tax positions, our effective tax rate would be reduced. Any adjustment to our uncertain tax positions would result in an adjustment of our tax credit carryforwards rather than resulting in a cash outlay.

PRO-DEX, INC. AND SUBSIDIARIES**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Information with respect to our accrual for unrecognized tax benefits is as follows (in thousands):

| | 2018 | June 30, | 2017 |
|--|-------------|-----------------|-------------|
| Unrecognized tax benefits: | | | |
| Beginning balance | \$ 446 | \$ | 446 |
| Additions based on federal tax positions related to the current year | 16 | | 18 |
| Additions based on state tax positions related to the current year | | | |
| Additions for tax positions of prior years | | | 1 |
| Reductions for tax positions of prior years | | | (19) |
| Ending balance | \$ 462 | \$ | 446 |

Although it is reasonably possible that certain unrecognized tax benefits may increase or decrease within the next twelve months due to tax examinations, settlement activities, expirations of statute of limitations, or the impact on recognition and measurement considerations related to the results of published tax cases or other similar activities, we do not anticipate any significant changes to unrecognized tax benefits over the next twelve months.

We recognize accrued interest and penalties related to unrecognized tax benefits in income tax expense when applicable. As of June 30, 2018, 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.

We 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, 2015 and later. However, because of net operating losses and research credit carryovers, substantially all of our tax years are open to audit.

8.**NOTES RECEIVABLE**

Monogram note receivable long-term

On April 19, 2017, we entered into a Secured Convertible Promissory Note (the *Promissory Note*) with Monogram Orthopaedics Inc. (*Monogram*). Monogram is a New York based medical device start-up specializing in precision, patient-specific orthopedic implants.

Pursuant to the terms of the Promissory Note, on April 19, 2017, we advanced Monogram \$450,000 and an additional \$350,000 on November 21, 2017, upon satisfaction of certain milestones, as determined by us in good faith. The Promissory Note bears interest at 4% per annum calculated on a 360-day year and matures on April 19, 2019, upon which the outstanding principal and accrued interest will become due and payable if not converted to Monogram's common stock. Accordingly, no interest payments have been made and we have placed the note on nonaccrual status since inception, based upon the likely conversion to common stock.

During the fourth quarter of fiscal 2018, we fully impaired the note receivable due to indications that Monogram had exhausted its cash and had been unable to obtain additional financing to enable continued research to commercialize their technology. The \$800,000 charge is recorded in asset impairment charges on the accompanying Consolidated Statement of Operations. While we do not expect to recover our investment, our contractual rights are intact should Monogram be successful in its endeavors to raise additional financing.

Loan Participation note receivable short-term

On September 20, 2017 (the *Closing Date*), we entered into a Participation Agreement with FS Special Opportunities I, L.P., a Minnesota limited partnership (*Principal*), pursuant to which we paid Principal \$1,150,000 in cash to purchase a 50% (*Participation Percentage*) undivided interest (the *Participation*) in Principal's \$2,300,000 loan (the *Loan*) to 414 New York LLC, a New York limited liability company (*Borrower*). The Participation constitutes the purchase by us of a property interest in the Loan from Principal and does not create a creditor-debtor relationship between us and Borrower. Borrower used the proceeds from the Loan to acquire a leasehold interest in certain real estate operated as a hotel in Manhattan, New York. If the Borrower were to default on the Loan, the Principal's recourse would be limited to taking a pledge of the equity interests of the Borrower. This would provide the Principal with the right to step into the Borrower's shoes to take control of the hotel's operations. We have no direct recourse, as we are not a party to the Loan.

PRO-DEX, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Pursuant to the loan agreement entered into on the Closing Date between Principal and Borrower, the Loan initially bears interest at a fixed rate of 22% per annum, with payments of all accrued and unpaid interest due monthly commencing on October 1, 2017 and on the first day of each month thereafter. Borrower may reduce the interest rate by 1% for each \$100,000 repayment of principal up to a maximum reduction of 2%, thereby reducing the interest rate to a minimum amount equal to 20% per annum. Interest income earned during the fiscal year ended June 30, 2018 totaled \$199,000. If the principal balance of the Loan is not paid in full by September 30, 2018, commencing on October 1, 2018 and continuing on the first day of the next 83 months thereafter, Borrower shall, in addition to the aforementioned monthly interest payments, pay installments of principal equal to 1/84th of the principal balance outstanding under the Loan as of September 30, 2018. We are entitled to receive from Principal the Company's Participation Percentage of any payments of principal and interest. We have classified this note receivable as short-term pursuant to representations that the Borrower has made to Principal. Raymond E. Cabillot, a director of the Company, is the managing partner of Farnam Street Capital, Inc. (Farnam) and Farnam is the founding partner of FS Special Opportunities I, L.P.

Fineline note receivable

On May 23, 2018, we completed the sale of substantially all of the assets of Fineline, which was engaged in the manufacture of plastic injection molds serving customers in a variety of industries. The aggregate purchase price was \$310,000, of which \$30,000 was paid in cash at closing and the balance of \$280,000 is to be paid to us under the terms of a five-year promissory note, which bears interest at 4% per annum and requires sixty equal monthly payments of principal and accrued interest in the amount of \$5,156.63 each, beginning February 15, 2019. We have determined that there is uncertainty regarding the collectability of this note. Therefore, we offset the gain on the sale of the division in the amount of approximately \$211,000, against the impairment of the note receivable because the fair market value of the collateral securing the note is less than the face amount of the note, as determined by us.

9.

NOTES PAYABLE AND FINANCING TRANSACTIONS

Farmers & Merchants Bank of Long Beach

On April 19, 2017, we entered into a Business Loan Agreement, dated effective March 28, 2017, with Farmers & Merchants Bank of Long Beach (FMB), providing for a \$500,000 revolving loan facility (the Revolving Loan

Facility). The Revolving Loan Facility is secured by substantially all of our assets and bears interest at prime plus 2 percent (currently 6.75%) and matured on March 28, 2018. During the initial loan period, we did not borrow any funds. As disclosed in a Form 8-K filed with the SEC on April 17, 2018, we entered into a Change in Terms Agreement and an Amendment #1 to Business Loan Agreement, each dated effective April 6, 2018, which extend the maturity date of the Revolving Loan Facility to March 28, 2019. This loan was terminated by us on September 4, 2018 (See Note 15).

Summit Financial Resources LP

On September 9, 2015, we entered into a Loan and Security Agreement (the Summit Loan) with Summit Financial Resources LP, whereby we could borrow up to \$1.0 million against our eligible receivables, as defined in the agreement. Borrowed funds bore interest at a rate of prime plus 2 percent and incurred an additional administrative fee of 0.7 percent on the monthly average outstanding balance. The Summit Loan had an initial period of 18 months. During the fiscal year ended June 30, 2017, we borrowed \$600,000 on a revolving basis under the Summit Loan, which amounts were paid in full prior to March 9, 2017, when we terminated the Summit Loan in accordance with its terms.

Jules & Associates/Hitachi Capital America Corporation

On July 21, 2016, we entered a master equipment lease agreement with Jules and Associates, Inc. to lease a specific machine used in our inspection process. The cost of the equipment was approximately \$106,000 and the lease provides for 36 monthly payments in the amount of \$3,121, as well as interim rent in the amount of \$7,388. The lease was subsequently assigned to Hitachi Capital America Corporation. The balance owed on the lease as of June 30, 2018 is approximately \$41,000.

PRO-DEX, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Fineline Molds

In conjunction with our acquisition of the assets of Fineline, we issued a promissory note to Fineline in the amount of \$100,000 which bore interest at 4% per annum and required sixteen equal quarterly payments of principal and accrued interest in the amount of \$6,794. The note was secured by all of the assets acquired by us from Fineline. During the quarter ended March 31, 2018, we paid the remaining note balance in full in anticipation of our sale of Fineline.

10.

COMMITMENTS AND CONTINGENCIES

Leases

We lease our office, production and warehouse facility in Irvine, California, (our corporate office) under an agreement that expires in September 2027. We leased our former San Dimas, California office until the sale of our Fineline division in May 2018 at which time it terminated. We leased our former Beaverton, Oregon office under an agreement that expired in July 2017. Upon the sale of the OMS division, we assigned the Beaverton lease to the purchaser of the division and received sublease income in the amount of \$43,000 during fiscal 2017, which was recorded as a reduction to rent expense. Our corporate office lease requires us to pay insurance, taxes, and other expenses related to the leased space.

Rent expense in fiscal 2018 and 2017 was \$551,000 and \$515,000, respectively. Minimum lease payments for future fiscal years ending June 30 are as follows (in thousands):

| Fiscal Year: | Operating Leases |
|--------------|-----------------------------|
| 2019 | \$ 448 |
| 2020 | 461 |
| 2021 | 475 |
| 2022 | 489 |

| | | |
|------------------------------|----|-------|
| 2023 | | 504 |
| Thereafter | | 2,316 |
| Total minimum lease payments | \$ | 4,693 |

Compensation Arrangements

Retirement Savings 401(k) Plan

The Pro-Dex, Inc. Retirement Savings 401(k) Plan (the 401(k) Plan) is a defined contribution plan we administer that covers substantially all our employees and is subject to the provisions of the Employee Retirement Income Security Act of 1974, as amended. Employees are eligible to participate in the 401(k) Plan when they have attained 19 years of age and then can enter into the 401(k) Plan on the first day of each calendar quarter. Participants are eligible to receive non-discretionary Pro-Dex matching contributions of 25% of their contributions up to 5% of eligible compensation. For the fiscal years ended June 30, 2018 and 2017, we recognized compensation expense amounting to \$54,000 and \$53,000, respectively, in connection with the 401(k) Plan.

Legal Matters

We are from time to time a party to various legal proceedings incidental to our business. There can be no certainty, however, that we may not ultimately incur liability or that such liability will not be material and adverse.

PRO-DEX, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

11.

SHARE-BASED COMPENSATION

Stock Option Plans

Through 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 Former Stock Option Plans). There was no share-based compensation expense related to the Former Stock Option Plans for the fiscal years ended June 30, 2018 and 2017 as all outstanding options under the Former Stock Option Plans are fully vested. The Employee Stock Option Plan and Director s Stock Option Plan were terminated in June 2015 and September 2014, respectively.

In September 2016, our Board approved the establishment of the 2016 Equity Incentive Plan, which was approved by our shareholders at the November 29, 2016 Annual Meeting. The 2016 Equity Incentive Plan provides for the award of up to 1,500,000 shares of the Company s common stock in the form of incentive stock options, nonstatutory stock options, stock appreciation rights, restricted shares, restricted stock units, performance awards and other stock-based awards. As of June 30, 2018, 200,000 performance awards have been granted under the 2016 Equity Incentive Plan.

Stock Options

There were no stock options granted during the fiscal years ended June 30, 2018 and 2017. As of June 30, 2018, there was no unrecognized compensation cost under the stock option plans as all outstanding stock options are fully vested. The intrinsic value of stock options outstanding and exercisable at June 30, 2018 was approximately \$272,000.

The following is a summary of stock option activity under the stock option plans for the fiscal years ended June 30, 2018 and 2017:

Outstanding Options

| | Number of Shares | Weighted-Average Exercise Price |
|--|-----------------------------|--|
| Balance, July 1, 2016 | 90,834 | \$ 1.95 |
| Options granted | | |
| Options canceled or expired | | |
| Options exercised | (33,834) | 2.07 |
| Balance, July 1, 2017 | 57,000 | \$ 1.88 |
| Options granted | | |
| Options canceled or expired | | |
| Options exercised | | |
| Balance, June 30, 2018 | 57,000 | \$ 1.88 |
| Stock Options Exercisable at June 30, 2018 | 57,000 | \$ 1.88 |

Performance Awards

In December 2017, the Compensation Committee of our Board of Directors granted 200,000 performance awards to our employees which will generally be paid in shares of our common stock. Whether any performance awards vest, and the amount that does vest, is tied to the completion of service periods that range from 7 months to 9.5 years at inception and the achievement of our common stock trading at certain pre-determined prices. The weighted average fair value of the performance awards granted was \$4.46, calculated using the weighted average fair market value for each award, using a Monte Carlo simulation. We recorded share-based compensation expense of \$187,000 for the fiscal year ended June 30, 2018 related to these performance awards. On June 30, 2018, there was approximately \$100,000 of unrecognized compensation cost related to these non-vested performance awards expected to be expensed over the weighted-average period of 4.89 years.

On July 1, 2018, it was determined by the Compensation Committee of our Board of Directors that the first of five tranches of the performance awards had been achieved and participants were awarded 40,000 shares of common stock. Each participant elected a net issuance to cover their individual withholding taxes and therefore the Company issued 24,727 shares.

PRO-DEX, INC. AND SUBSIDIARIES**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Employee Stock Purchase Plan**

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. Our Board of Directors also approved the provision that shares formerly reserved for issuance under the Former Stock Option Plans 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 fiscal years ended June 30, 2018 and 2017, shares totaling 6,733 and 3,794 were purchased respectively, and allocated to participating employees based upon their contributions at weighted average prices of \$5.60 and \$4.74, respectively. On a cumulative basis, since the inception of the ESPP, employees have purchased a total of 16,123 shares. During the fiscal year ended June 30, 2018 and 2017, we recorded stock compensation expense in the amount of \$7,000 and \$3,000, respectively, relating to the ESPP.

12.**MAJOR CUSTOMERS & SUPPLIERS**

Customers that accounted for sales in excess of 10% of our total sales in either of fiscal year 2018 or 2017, is as follows (in thousands, except percentages):

| | Years Ended June 30, | | | |
|-------------------------|-----------------------------|-------------------------|---------------|-------------------------|
| | 2018 | | 2017 | |
| | Amount | Percent of Total | Amount | Percent of Total |
| Total revenue | \$ 22,465 | 100% | \$ 21,943 | 100% |
| Customer concentration: | | | | |
| Customer 1 | \$ 12,530 | 56% | \$ 10,939 | 50% |

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| | | | | | | |
|------------|----|--------|-----|----|--------|-----|
| Customer 2 | | 2,625 | 11% | | 1,566 | 7% |
| Customer 3 | | 2,232 | 10% | | 1,761 | 8% |
| Total | \$ | 17,387 | 77% | \$ | 14,266 | 65% |

Information with respect to accounts receivable from those customers who comprised more than 10% of our gross accounts receivable at either June 30, 2018 or June 30, 2017 is as follows (in thousands, except percentages):

| | June 30, 2018 | | | June 30, 2017 | | |
|---------------------------------|----------------------|-------|------|----------------------|-------|------|
| Total gross accounts receivable | \$ | 2,969 | 100% | \$ | 3,541 | 100% |
| Customer concentration: | | | | | | |
| Customer 1 | \$ | 1,673 | 56% | \$ | 2,187 | 62% |
| Customer 2 | | 679 | 23% | | 554 | 16% |
| Total | \$ | 2,352 | 79% | \$ | 2,741 | 78% |

During fiscal 2018 and 2017, we had one supplier that accounted for 11 percent and 10 percent of total purchases, respectively. Accounts payable due to this same significant supplier represented 17 percent and 12 percent of total accounts payable as of June 30, 2018 and 2017, respectively.

PRO-DEX, INC. AND SUBSIDIARIES**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

13.

NET INCOME PER SHARE

We calculate basic earnings per share by dividing net income by the weighted average number of common shares outstanding during the reporting period. Diluted earnings per share reflects the effects of potentially dilutive securities. The summary of the basic and diluted earnings per share calculations for the years ended June 30, 2018 and 2017 is as follows (in thousands, except per share data):

| | Years Ended June 30, | |
|---|-----------------------------|-------------|
| | 2018 | 2017 |
| Basic: | | |
| Income from continuing operations | \$ 1,621 | \$ 4,841 |
| Weighted average shares outstanding | 4,305 | 4,040 |
| Basic earnings per share from continuing operations | \$ 0.38 | \$ 1.20 |
| Income from discontinued operations | \$ | \$ 243 |
| Weighted average shares outstanding | 4,305 | 4,040 |
| Basic earnings per share from discontinued operations | \$ 0.00 | \$ 0.06 |
| Net income | \$ 1,621 | \$ 5,084 |
| Weighted average shares outstanding | 4,305 | 4,040 |
| Basic earnings per share | \$ 0.38 | \$ 1.26 |
| Diluted: | | |
| Income from continuing operations | \$ 1,621 | \$ 4,841 |
| Weighted average shares outstanding | 4,305 | 4,040 |
| Effect of dilutive securities – stock options | 40 | 37 |
| Weighted average shares used in calculation of diluted earnings per share | 4,345 | 4,077 |
| Diluted earnings per share from continuing operations | \$ 0.37 | \$ 1.19 |
| Income from discontinued operations | \$ | \$ 243 |
| Weighted average shares used in calculation of diluted earnings per share | 4,345 | 4,077 |
| Diluted earnings per share from discontinued operations | \$ | \$ 0.06 |
| Net income | \$ 1,621 | \$ 5,084 |
| Weighted average shares used in calculation of diluted earnings per share | 4,345 | 4,077 |
| Diluted earnings per share | \$ 0.37 | \$ 1.25 |

14.

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 has approved the adoption of several prearranged share repurchase plans intended to qualify for the safe harbor Rule 10b5-1 under the Securities Exchange Act of 1934, as amended (10b5-1 Plan or Plan). During the quarter ended September 30, 2016, our Board approved a 10b5-1 Plan, which became effective on September 8, 2016 and terminated on the earlier of September 8, 2017 or when and if the maximum shares were repurchased. During the quarter ended December 31, 2016, the Investment Committee of our Board approved an additional concurrently running 10b5-1 Plan, which became effective on December 8, 2016 and terminates on the earlier of December 8, 2017 or when and if the maximum shares were repurchased. In February, 2017 our Board terminated the two effective 10b5-1 Plans in conjunction with the approval of our At The Market Offering Agreement (ATM or ATM Agreement) further described below. During the fiscal year ended June 30, 2017, we repurchased 63,496 shares at an aggregate cost of \$312,000, inclusive of fees under the Plans.

On March 9, 2018, the Investment Committee of our Board approved a 10b5-1 Plan, which became effective on March 14, 2018 and terminates on the earlier of March 13, 2019 or when and if the maximum shares are repurchased. During the fiscal year ended June 30, 2018, we repurchased 33,026 shares at an aggregate cost, inclusive of fees under the plan of \$220,000. On a cumulative basis, we have repurchased a total of 265,983 shares under the share repurchase program at an aggregate cost of \$1.1 million. All repurchases under the 10b5-1 Plans were administered through an independent broker.

PRO-DEX, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

At The Market Offering Agreement

In February 2017, our Board approved an ATM Agreement with Ascendant Capital Markets, LLC (Ascendant). The ATM Agreement allows us to sell shares of our common stock pursuant to specific parameters defined by us as well as those defined by the SEC and the ATM Agreement. During the fiscal year ended June 30, 2017, we sold 8,276 shares of common stock at average prices of \$6.04 and raised net proceeds of \$48,000. The proceeds collected were accounted for as a reduction of the prepaid expenses relating to establishing the ATM. During the fiscal year ended June 30, 2018, we sold 332,189 shares of common stock under the ATM at average prices of \$7.02 per share, resulting in proceeds to us of \$2.3 million, net of commissions and fees. From the inception of the ATM in February 2017 through December 31, 2017, we have sold 340,465 shares of common stock for gross proceeds of \$2,311,000 net of commissions and fees paid to Ascendant totaling \$72,000. In December 2017, our Board suspended the ATM indefinitely. Our Board has the discretion to reactivate the ATM prior to February 16, 2020, the expiration of the ATM Agreement, unless earlier terminated by Ascendant or us.

15.

SUBSEQUENT EVENTS

On September 6, 2018 (the Effective Date), as reported in our Current Report filed with the SEC on September 7, 2018, we entered into a Credit Agreement with Minnesota Bank & Trust, a Minnesota state banking corporation (MBT), providing for a \$5,000,000 term loan (the Term Loan) as well as a \$2,000,000 revolving loan (the Revolving Loan) and together with the Term Loan, collectively the Loans), evidenced by a Term Note A and a Revolving Credit Note made by us in favor of MBT. The Loans are secured by substantially all of our assets pursuant to a Security Agreement entered into on the Effective Date between us and MBT. We paid loan origination fees to MBT on the Effective Date in the amount of \$60,000.

The Term Loan matures on October 1, 2025 and bears interest at a fixed rate of 5.53% per annum. An initial payment of interest only is due on October 1, 2018. Commencing November 1, 2018 and continuing on the first day of each subsequent month thereafter until the maturity date, we are required to make payments of principal and interest on the Term Loan of \$71,921.43, plus any additional accrued and unpaid interest through the date of payment. The Revolving Loan matures on September 6, 2019 unless earlier terminated pursuant to its terms and bears interest at the greater of (a) 4.5% or (b) the difference of the prime rate as published in the Money Rates section of the Wall Street Journal minus 0.50%. Commencing on the first day of each month after we initially borrow against the Revolving Loan and each month thereafter until maturity, we are required to pay all accrued and unpaid interest on the Revolving Loan through the date of payment. Any principal on the Revolving Loan that is not previously prepaid shall be due

and payable on the maturity date (or earlier termination of the Revolving Loan).

Any payment on the Loans not made within seven days after the due date is subject to a late payment fee equal to 5% of the overdue amount. Upon the occurrence and during the continuance of an event of default, the interest rate of both Loans will be increased by 3% and MBT may, at its option, declare the Loans immediately due and payable in full.

The Credit Agreement and Security Agreement contain representations and warranties, affirmative, negative and financial covenants, and events of default that are customary for loans of this type.

In conjunction with the above, we terminated our loan with Farmers & Merchants Bank of Long Beach effective September 4, 2018.

On September 10, 2018, we discovered a supplier quality issue in one of our legacy batteries which will require a product recall. We are currently examining the components that may contain particulates which should have been rejected by our supplier and we are identifying all lots that will be included in the recall as well as the customers that are impacted by the recall. No significant current contracts are affected. For illustrative purposes, to describe the magnitude of the recall, we sold \$338,000 of these batteries during fiscal 2018. We are currently investigating the issue and will be able to estimate our expected recall related expenses once the affected lots are identified, anticipated units to be returned are quantified, and potential re-work solutions are identified. At this time, we do not know the amount of other costs that may be incurred related to the recall or any amounts that may be recovered either through our supplier or our \$1 million commercial product recall insurance policy, which contains a \$50,000 deductible per occurrence. As our analysis is ongoing, we do not know at this time whether or not we will file a claim with our insurance.

ITEM 9.

CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A.

CONTROLS AND PROCEDURES

Our Chief Executive Officer and Chief Financial Officer (our principal executive officer and principal financial officer) have concluded, based on their evaluation as of June 30, 2018, that 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)) are effective at a reasonable assurance level to ensure that information required to be disclosed by us in the reports filed or submitted by us under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, including to ensure that information required to be disclosed by us in the reports we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act). Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework set forth in the *2013 Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in May 2013. Based on this evaluation, our management concluded that our internal control over financial reporting was effective as of June 30, 2018.

Our internal control over financial reporting is supported by written policies and procedures that:

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

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

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

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

This annual report does not include an attestation report of our registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by our registered public accounting firm pursuant to rules of the SEC that apply to smaller reporting companies that permit us to provide only management's attestation in this annual report.

During the quarter ended June 30, 2018, there were no changes in the Company's internal controls over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act) that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

ITEM 9B.

OTHER INFORMATION

None.

PART III

ITEM 10.

DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this Item is incorporated herein by reference to our definitive Proxy Statement, which will be filed within 120 days of June 30, 2018, and delivered to stockholders in connection with our 2018 annual meeting of shareholders.

ITEM 11.

EXECUTIVE COMPENSATION

The information required by this Item is incorporated herein by reference to our definitive Proxy Statement, which will be filed within 120 days of June 30, 2018, and delivered to stockholders in connection with our 2018 annual meeting of shareholders.

ITEM 12.

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this Item is incorporated herein by reference to our definitive Proxy Statement, which will be filed within 120 days of June 30, 2018, and delivered to stockholders in connection with our 2018 annual meeting of shareholders.

ITEM 13.

CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this Item is incorporated herein by reference to our definitive Proxy Statement, which will be filed within 120 days of June 30, 2018, and delivered to stockholders in connection with our 2018 annual meeting of shareholders.

ITEM 14.

PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required by this Item is incorporated herein by reference to our definitive Proxy Statement, which will be filed within 120 days of June 30, 2018, and delivered to stockholders in connection with our 2018 annual meeting of shareholders.

PART IV

ITEM 15.

EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a)(3) Exhibits

Reference is made to the Exhibit Index beginning on page 52 of this report.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on September 13, 2018.

PRO-DEX, INC.

By: Richard L. Van Kirk
Richard L. Van Kirk
President, Chief Executive Officer and Director
(Principal Executive Officer)

POWER OF ATTORNEY

We, the undersigned directors and officers of Pro-Dex, Inc., do hereby constitute and appoint Richard L. Van Kirk, as our true and lawful attorney-in-fact and agent with power of substitution, to do any and all acts and things in our name and behalf in our capacities as directors and officers and to execute any and all instruments for us and in our names in the capacities indicated below, which such attorney-in-fact and agent may deem necessary or advisable to enable said corporation to comply with the Securities Exchange Act of 1934, as amended, and any rules, regulations and requirements of the Securities and Exchange Commission, in connection with this Annual Report on Form 10-K, including specifically but without limitation, power and authority to sign for us or any of us in our names in the capacities indicated below, any and all amendments hereto; and we do hereby ratify and confirm all that said attorney-in-fact and agent, shall do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| Signature | Title | Date |
|---|---|--------------------|
| /s/ Richard L. Van Kirk Richard L. Van Kirk | President, Chief Executive Officer, and Director (Principal Executive Officer) | September 13, 2018 |
| /s/ Alisha K. Charlton | Chief Financial Officer (Principal Financial Officer) | September 13, 2018 |

Alisha K. Charlton

/s/ Nicholas J. Swenson

Chairman of the Board, Director

September 13, 2018

Nicholas J. Swenson

/s/ Raymond E. Cabillot

Director

September 13, 2018

Raymond E. Cabillot

/s/ William J. Farrell III

Director

September 13, 2018

William J. Farrell III

/s/ David C. Hovda

Director

September 13, 2018

David C. Hovda

INDEX TO EXHIBITS

| Exhibit No. | Description |
|--------------------|--|
| 3.1 | <u>Articles of Incorporation (incorporated herein by reference to Exhibit 3.1 to the Company's Form 8-K filed April 23, 2007).</u> |
| 3.2 | <u>Articles of Amendment to Articles of Incorporation (incorporated herein by reference to Exhibit 3.1 to the Company's Form 8-K filed December 5, 2007).</u> |
| 3.3 | <u>Articles of Amendment to Articles of Incorporation (incorporated herein by reference to Exhibit 3.1 to the Company's Form 8-K filed June 18, 2010).</u> |
| 3.4 | <u>Amended and Restated Bylaws, dated January 31, 2011 (incorporated herein by reference to Exhibit 3.1 to the Company's Form 8-K filed February 4, 2011).</u> |
| 10.1* | <u>Second Amended and Restated 2004 Stock Option Plan (incorporated herein by reference to Exhibit 4.1 to the Company's Form S-8 filed February 15, 2012).</u> |
| 10.2* | <u>Amended and Restated 2004 Directors Stock Option Plan (incorporated herein by reference to Exhibit 4.2 to the Company's Form S-8 filed February 15, 2012).</u> |
| 10.3* | <u>Form of Indemnification Agreement for directors and certain officers (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed October 29, 2008).</u> |
| 10.4 | <u>Lease agreement with Irvine Business Properties, dated August 3, 2007 (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed August 23, 2007).</u> |
| 10.5 | <u>First Amendment To Lease July 2013 by and between Irvine Business Properties and Pro-Dex, Inc., dated effective July 1, 2013 (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed July 17, 2013).</u> |
| 10.6 | <u>Asset Purchase Agreement dated December 8, 2014 by and between Pro-Dex, Inc., Fineline Molds and the shareholders of Fineline Molds (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed December 11, 2014).</u> |
| 10.7* | <u>Pro-Dex, Inc. Amended and Restated Employee Severance Policy effective as of September 16, 2014 (incorporated herein by reference to Exhibit 10.5 to the Company's Form 10-Q filed May 14, 2015).</u> |
| 10.8 | <u>Loan and Security Agreement, dated September 9, 2015, between Summit Financial Resources, L.P. and Pro-Dex, Inc. (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed on September 14, 2015).</u> |
| 10.9 | <u>Intercreditor Agreement, dated September 9, 2015, among Summit Financial Resources, L.P., Fineline Molds and Pro-Dex, Inc. (incorporated herein by reference to Exhibit 10.2 to the Company's Form 8-K filed on September 14, 2015).</u> |
| 10.10 | <u>Agreement for Sale and Purchase of Business Assets dated January 27, 2017 by and between Pro-Dex, Inc. and OMS Motion, Inc. (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed on January 30, 2017).</u> |
| 10.11 | <u>Noncompetition and Nonsolicitation Agreement dated January 27, 2017 by and between Pro-Dex, Inc. and OMS Motion, Inc. (incorporated herein by reference to Exhibit 10.2 to the Company's Form 8-K filed on January 30, 2017).</u> |
| 10.12 | <u>At the Market Offering Agreement, dated February 16, 2017 by and between Pro-Dex, Inc. and Ascendant Capital Markets LLC (incorporated herein by reference to Exhibit 1.1 to the Company's Form 8-K filed on February 16, 2017).</u> |
| 10.13 | <u>Business Loan Agreement, dated March 28, 2017 between Pro-Dex, Inc. and Farmers and Merchants Bank of Long Beach (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K</u> |

- filed on April 21, 2017).
- 10.14^Δ Secured Convertible Promissory Note, dated April 19, 2017 by and between Pro-Dex, Inc. and Monogram Orthopaedics Inc. (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed on April 25, 2017).
- 10.15 Second Amendment to Standard Industrial/Commercial Multi-Tenant Lease Net by and between Irvine Business Properties and Pro-Dex, Inc., dated September 19, 2017 (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed on September 20, 2017).
- 10.16 Participation Agreement by and between FS Special Opportunities I, L.P. and Pro-Dex, Inc., dated September 20, 2017 (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed on September 25, 2017).
- 10.17* Form of Performance Award Agreement for Employees of Pro-Dex, Inc. 2016 Equity Incentive Plan (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed on December 8, 2017).

| | |
|---------|--|
| 10.18 | <u>Asset Purchase Agreement by and between Mike Bynum and Pro-Dex, Inc., dated April 11, 2018 (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed on April 16, 2018).</u> |
| 10.19 | <u>Change in Terms Agreement, dated April 6, 2018, by between Farmers and Merchants Bank of Long Beach and Pro-Dex, Inc. (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed on April 17, 2018).</u> |
| 10.20 | <u>Amendment #1 to Business Loan Agreement, dated April 6, 2018, by between Farmers and Merchants Bank of Long Beach and Pro-Dex, Inc. (incorporated herein by reference to Exhibit 10.2 to the Company's Form 8-K filed on April 17, 2018).</u> |
| 10.21 | <u>Secured Promissory Note by and between Four Boys Industries, Inc. and Pro-Dex, Inc., dated May 9, 2018 (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed on May 30, 2018).</u> |
| 10.22 | <u>Credit Agreement, dated September 6, 2018 between Pro-Dex, Inc. and Minnesota Bank & Trust (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed on September 7, 2018).</u> |
| 10.23 | <u>Security Agreement, dated September 6, 2018 by Pro-Dex, Inc. in favor of Minnesota Bank & Trust (incorporated herein by reference to Exhibit 10.2 to the Company's Form 8-K filed on September 7, 2018).</u> |
| 10.24 | <u>Term Note A, dated September 6, 2018 by Pro-Dex, Inc. in favor of Minnesota Bank & Trust (incorporated herein by reference to Exhibit 10.3 to the Company's Form 8-K filed on September 7, 2018).</u> |
| 10.25 | <u>Revolving Credit Note, dated September 6, 2018 by Pro-Dex, Inc. in favor of Minnesota Bank & Trust (incorporated herein by reference to Exhibit 10.4 to the Company's Form 8-K filed on September 7, 2018).</u> |
| 23 | <u>Consent of Independent Registered Public Accounting Firm.</u> |
| 31.1 | <u>Certification of the Chief Executive Officer Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u> |
| 31.2 | <u>Certification of the Chief Financial Officer Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u> |
| 32 | <u>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.</u> |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Taxonomy Extension Schema Document |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |
| 101.DEF | XBRL Extension Definition Linkbase Document |

Filed herewith.

Δ Portions of this exhibit indicated in the body of the exhibit by “#####” have been omitted pursuant to the Company's request for confidential treatment under Rule 24b-2 of the Securities Exchange Act of 1934, as amended, and the omitted material has been separately filed with the Securities and Exchange Commission.

* Denotes management contract or compensatory arrangement.