PRO DEX INC
Form 10KSB
September 28, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-KSB

[X] ANNUAL REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934.

For the fiscal year ended June 30, 2007

OR

[ ] TRANSITION REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934. FOR THE TRANSITION PERIOD FROM _____TO _____.

Commission File Number 0-14942

PRO-DEX, INC.
(Name of small business issuer in its charter)

Colorado	**84-1261240**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

151 E. Columbine Avenue, Santa Ana, California	**92707**
(Address of principal executive offices)	**(Zip Code)**

Issuer's telephone number: (714) 241-4411

Securities registered under Section 12(b) of the Exchange Act:

Title of each class	**Name of each exchange on which registered**
Common Stock, no par Value	**NASDAQ Capital Market**

Securities registered under Section 12(g) of the Exchange Act:

None

(Title of class)

Check whether the issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. [ ]

Check whether the issuer (1) filed all reports required by Section 13 or 15(d) of the Exchange Act during the past 12 months, and (2) has been subject to such filing requirements for the past 90 days.

Yes [X] No [ ]

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will 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-KSB or any amendment to this Form 10-KSB. [X]

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

Yes [ ] No [X]

State issuer's revenues for its most recent fiscal year: $21,563,000.

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the average bid and asked price of such common equity as of August 31, 2007: $10,220,725. 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 determination of affiliate status is not a determination for other purposes.

The number of shares outstanding of each of the issuer s classes of Common Stock outstanding as of the latest practicable date: 9,718,366 shares of Common Stock, no par value, as of August 31, 2007.

DOCUMENTS INCORPORATED BY REFERENCE: Part III incorporates by reference certain information from the registrant's definitive proxy statement (the "Proxy Statement") for the 2007 Annual Meeting of Shareholders.

Transitional Small Business Disclosure Format: Yes [ ] No [X]

PART I

Cautionary statement pursuant to safe harbor provisions of the Private Securities Litigation Reform Act of 1995.

When used in this report on Form 10-KSB, the words "expects, "anticipates," "estimates," "believes," "hopes," "intends," "forecasts" and similar expressions are intended to identify "forward-looking statements." These statements which are not historical or current facts are made pursuant to the safe harbor provisions of Section 27a of the Securities Act of 1933, as amended and Section 21e of the Securities Exchange Act of 1934, as amended, and the Company intends that such forward-looking statements be subject to those safe harbor provisions for such statements. The Company wishes to caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date of this report. While forward-looking statements represent management's best judgment as to what may occur in the future, they are subject to risks, uncertainties and important factors beyond the control of the Company that could cause actual results and events to differ materially from historical results of operations and events as well as those presently anticipated or projected. These factors include adverse economic conditions, entry of new and stronger competitors, capital availability, unexpected costs, failure to capitalize upon access to new customers, and marketplace delisting. Other risks and uncertainties which may affect forward-looking statements about the Company's business and prospects include, but are not limited to, the ramifications of the continued industry consolidation of dental and medical products manufacturers, dealers and distributors, managed health care, the Company's ability to effectively integrate operations of acquired companies, market acceptance and support of new products, maintaining favorable supplier relationships, the inability to engage qualified human resources as needed, regulatory compliance and general economic conditions. The Company disclaims any obligations subsequently to revise any forward-looking statements to reflect events or circumstances after the date of such statement or to reflect the occurrence of anticipated or unanticipated events.

Item 1. Description of Business

Company Overview

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

Pro-Dex s principal headquarters are located at 151 E. Columbine Avenue, Santa Ana, California 92707 and our phone number is 714-241-4411. Our Internet address is www.pro-dex.com . Our annual reports on Form 10-KSB, quarterly reports on Form 10-QSB, current reports on Form 8-K, amendments to those reports and other Securities and Exchange Commission (SEC) filings, are available free of charge through our website as soon as reasonably practicable after such reports are electronically filed with, or furnished to, the SEC. In addition, our Code of Ethics and other corporate governance documents may be found on our website at the Internet address set forth above. Our filings with the SEC may also be read and copied at the SEC s Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC at www.sec.gov .

Description of Business

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

North America. Other revenue sources include designing and manufacturing miniature pneumatic motors, fractional horsepower DC motors and motion control systems for industrial applications in the automotive, aerospace, and apparel industries.

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

Company-funded research and development supports the development of generic rotary drive, motion control and electric motor technology platforms. We seek customer-funded projects to customize these platforms to specific customer requirements. Company-funded research and development projects are generally expected to convert to customer-funded projects within six to eighteen months. Company funded research and development costs not associated with contracts or purchase orders are expensed as incurred. In the year ended June 30, 2007, $2,474,000 was expensed; an increase of $465,000 from the $2,009,000 expensed in the year ended June 30, 2006. The addition of costs of Pro-Dex Astromec, our wholly owned subsidiary established in January 2006, accounted for $184,000 of the increase and the remainder was attributable to increased internal costs and external engineering consulting fees for product improvement, specialty design and validation work.

In fiscal year 2007, there was a $95,000 change in revenue from customer-funded research and development as there was $24,000 negative revenue from customer-funded research and development as fees were refunded due to cancelled development projects in the year ended June 30, 2007 compared to recognizing $71,000 in revenue in the year ended June 30, 2006. The reduction in customer-funded research and development fees reflected efforts that were focused on pre-contract development work, upgrading current products and supporting warranty work

For customer-funded development projects, costs are capitalized and recognized as a cost of sales when specific deliverables within the development contracts are produced, matching the costs to the revenue. For the year ended June 30, 2007, $124,000 was recognized as cost of sales reflecting the recognition of inventory costs associated with the cancelled development projects, compared to $54,000 recognized as cost of sales for the year ended June 30, 2006, reflecting the completion of various development contracts during the year.

The Company s revenue is derived from five main customer types. The proportion of sales compared to our total sales, sales to each customer type and sales by location are noted in the tables below:

Sales by customer type ($'000)	2007		2006		2005		2004		2003	
Dental	$ 4,298	20%	$ 3,789	22%	$ 3,368	24%	$ 4,578	32%	$ 5,156	43%
Medical	9,453	44%	6,447	38%	5,849	42%	5,864	41%	3,357	28%
Industrial	3,317	15%	3,753	22%	3,570	26%	2,533	18%	2,278	19%
Aerospace	2,445	11%	1,194	7%	--	--	--	--	--	--
Repairs, Government and other	2,050	10%	1,878	11%	1,047	8%	1,225	9%	1,199	10%
Total Sales	$21,563	100%	$17,061	100%	$13,834	100%	$14,200	100%	$11,990	100%

Sales by location ($'000)	2007		2006		2005		2004		2003	
Santa Ana	$13,852	64%	$10,823	63%	$ 9,946	72%	$10,900	77%	$ 9,281	77%
Beaverton	4,121	19%	4,585	27%	3,888	28%	3,300	23%	2,709	23%
Carson City	3,590	17%	1,653	10%	-	-	-	-	-	-
Total Sales	$21,563	100%	$17,061	100%	$13,834	100%	$14,200	100%	$11,990	100%

Medical product sales represent the manufacture of products that utilize proprietary designs developed by us under exclusive design and supply agreements. Our dental products are sold to original equipment manufacturers and dental

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

In 2007, the top 20 customers accounted for 77% of our sales, compared to 73% in 2006. In 2007, our two largest customers accounted for 41% of such sales with the largest customer accounting for over 23% of our sales. This compares to 2006 when our two largest customers accounted for 33% of our sales with the largest customer accounting for 22% of such sales. Our larger customers, based on revenue, include Smith and Nephew, Medtronic, Sullivan Schein, Lawrence Livermore National Laboratories, Monogram, and Benchmark Electronics. In many cases, disclosure of other larger customer names is prohibited by confidentiality agreements with such entities. We have no plans to discontinue the sales relationships with our existing significant customers.

In the second quarter of 2007, one of our major customers advised us that it plans to internally manufacture two of the products that we developed for them and have manufactured for the past four years. This decision is consistent with this customer s general strategy of vertical integration and their targeted time deadline for the transition is January 1, 2008. This customer represents sales of $2,314,000 in 2007 and $1,431,000 in 2006. At this point, the customer has purchased and has expressed its intention to continue to purchase some of the major components for these products from us, as these components contain our proprietary technology, although they are under no obligation to make such purchases. Such major components could account for as much as 50% of the price of the fully manufactured product. As a result of this advisement, no existing purchase orders were cancelled for these two products and the customer has placed a blanket purchase order for delivery of the products throughout calendar year 2007. We have no other knowledge that other significant customers have any plans to discontinue their relationships with us, although the relationships may change over time.

All of the raw materials used to manufacture our products are purchased from various suppliers and are available from several sources. Precipart Corporation, Tyco Precision Interconnect and Transicoil are some examples of our key suppliers. 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 Pro-Dex. Pro-Dex has no exclusive arrangements with any of its suppliers.

Our commitment to quality design and manufacturing are demonstrated by our three independently verified certifications for maintaining quality processes and products. We hold the following certifications: ISO 13485:2003, the Medical Device Directive 93\42\EEC Annex II, and CMDCAS (Canadian Medical Device Regulation).

At the present time, we are generally able to fill orders for recurring product within sixty (60) days from initial order receipt. At June 30, 2007, we had a backlog, including orders for delivery beyond 60 days, of $10.1 million compared with a backlog of $11.7 million at June 30, 2006. We expect to ship most of our backlog in fiscal year 2008 and the remainder in fiscal year 2009. The decreased backlog from 2006 is due normal fluctuations in the timing of receipt and shipment of orders. Backlog reductions in medical/dental products of approximately $1.1 million, due to the slow down in new product development, were offset by increases in motor component orders of approximately $0.5 million. We do not typically experience seasonal fluctuations in our new order bookings, but may experience variability in our new order bookings due to the timing of major new product launches. Similarly, we do not typically experience seasonal fluctuations in our shipments and revenues.

We sell our products using several methods; directly to the customer, directly to original equipment manufacturers and through a network of high technology and dental product distributors within North America. Internationally, we maintain sales agreements with foreign distributors or sell through the domestic subsidiaries of foreign customers.

Competition

The markets for products in the healthcare, fractional motors, motion control and factory automation industries 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 healthcare, fractional motors, motion control and factory automation related companies. Competitive pressures and other factors, such as new product or new technology introductions by us 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 company-funded and customer-funded research and development programs. These product development programs are important to both maintain and improve our market position. The net amounts spent on company-funded research and development activities in 2007 and 2006 were approximately $2.5 million and $2.0 million, respectively. Our research and development effort involves the design and manufacture of products that perform specific applications for our customers. We continue to target our research and development expenses toward three goals:

- expanding our knowledge base in the medical device, fractional motor and motion control industry to solidify our products with current customers and expand our customer base;
- general technical advances; and
- enhancements of current product lines.

One of our strategies is to gain a greater commitment level from our customers to share research and development costs by billing them for non-recurring engineering expenses. The fees received for non-recurring engineering expenses do not, however, represent a significant portion of our revenue.

Employees

At June 30, 2007, we had 124 full-time employees compared to 122 full-time employees at June 30, 2006. At June 30, 2007, there were 86 persons employed at the Santa Ana location, 26 persons employed at the Carson City location

and 12 persons employed at the Beaverton location compared to 86 persons employed at the Santa Ana location, 24 persons employed at the Carson City location and 12 persons employed at the Beaverton location at June 30, 2006. Due to the high level of shipments in the fourth quarter of 2007, the use of temporary labor from temporary staffing agencies was increased and we employed 7 agency temps at June 30, 2007, up from 2 agency temps at June 30, 2006.

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

Our manufacture and distribution of dental and medical devices are subject to a number of state and federal regulatory bodies, including state dental boards and the Food and Drug Administration ("FDA"). The statutes, regulations, administrative orders, and advisories that affect the Company's 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 an ongoing risk that one or more of our activities may at some point be determined to have been 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, our costs to achieve such a determination and the intervening loss of business could adversely affect or even terminate a portion of our business. A change in such laws or regulations at any time may have an adverse effect on our operations. Notwithstanding the risks inherent in our business, management believes that our operations are in compliance with applicable laws and regulations.

The FDA regulates our dental and medical products as Class 1, Class 2 and Class 3 medical devices. 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. While our management is confident that our products and processes fully comply with applicable laws and regulations, we are unable to predict the outcome of any such investigation or review, pending its completion.

Our management believes that our business is conducted in a manner consistent with Environmental Protection Agency (EPA) regulations governing disposition of industrial waste materials. While our management is confident 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 in the future be undertaken with respect to our products or processes.

Our management believes that we follow Good Manufacturing Practices for all of our products at each of our locations.

Patents, Trademarks, and Licensing Agreements

We hold patents relating to intraosseous dental anesthesia delivery, multi-axis motion controllers and our miniature rotary drive products. Our patents have varying expiration dates. The near term expiration of the patents, if any, is not expected to cause any change in the Company s revenue generating operations as the revenue from the products associated with those patents would not be material.

We believe that the use of the patents acquired in connection with the 1995 OMS and Micro Motors acquisitions as well as the patents acquired with the intraosseous dental anesthesia delivery (Intraflow) acquisition is neither infringed upon by any third party, nor infringes upon any prior art of any third party. We are unable to assess the validity, scope, or defensibility of our patents with any degree of certainty, and any challenge to or claim of infringement relating to our patents could materially and adversely affect our business and results of operations.

We have certain trademarks relating to our miniature pneumatic motor products, including Dynatorq™, Dynasurg™, PDL™, Micro Motors™, Micro Handpiece™ and Intraflow™. We have filed for federal trademark protection for OMS-EZ™.

We have not entered into any licensing or franchising agreements for revenue generating purposes, however we do have a royalty agreement in place for a previously designed product. This income is reflected as other income and not revenue .

Risk Factors

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

The markets for healthcare, factory automation and small motor manufacturing industries 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 healthcare, factory automation and small motor manufacturing related companies. Competitive pressures and other factors, such as new product or new technology introductions by us or our competitors may result in price or market share erosion that could have a material adverse effect on the 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.

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

Our revenues 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; the extent and timing of eligible product returned for repair or replacement under warranty coverage; 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; deferrals of customer orders and deliveries; changes in our strategy; personnel changes; and general market/economic factors.

Because a significant percentage of our expenses are relatively fixed, a variation in the timing of sales can cause significant variations 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.

Due to all of the foregoing factors, it is possible that in some future quarter(s), our operating results may be below the expectations of public market analysts and investors. In such event, the price of our Common Stock would likely be materially adversely affected.

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

We currently derive a substantial part of our net revenues from sales of our healthcare, factory automation and small motor products and services. We believe that a primary factor in the market acceptance of our product and services is the value that is created for our customers by those products and services. 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. We have historically expended a significant percentage of our net revenues 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 new products or product enhancements do not achieve market acceptance, our business, results of operations and financial condition could be materially adversely affected.

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 healthcare, factory automation and small motor markets are 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 the Company's 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 are ultimately funded by sales growth. 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.

In response to increasing market demand, we are currently developing new products and updating existing products. There can be no assurance that we will successfully develop these new products or that these products will operate successfully, or that any such development, even if successful, 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 face the risks and uncertainties that are associated with litigation 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. The uncertainty associated with potential litigation may have an adverse impact on our business. In particular, such litigation could impair our relationships with existing customers and our ability to obtain new customers. Defending or prosecuting such litigation may result in a diversion of management's time and attention away from business operations, which could have a material adverse effect on our business, results of operations and financial condition.

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 can be found or found on a timely basis to satisfy customer demands and avoid potential claims or litigation. Such matters could have a material and adverse effect upon our business, results of operations and financial condition.

There can be no assurance that such litigation will 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 rely heavily on our proprietary technology which, if not properly protected or 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 intellectual property and rely on exclusive development and supply agreements, confidentiality procedures, and employee nondisclosure agreements to protect our intellectual property.

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 or that any such assertion will not require us to enter into a license agreement or royalty arrangement with the party asserting the claim.

Our failure to manage growth could harm us by having a material adverse effect on our business and results of operations.

We have in the past experienced periods of growth that have placed, and may continue to place, a significant strain on our resources. We also anticipate expanding our overall development, marketing, sales, management and training capacity as market demand requires. In the event we are unable to identify, hire, train and retain qualified individuals in such capacities within a reasonable timeframe, such failure could have a material adverse effect on the Company.

In addition, our ability to manage future increases, in the scope of our operations or personnel may depend on significant expansion of our research and development, marketing and sales, management, and administrative and financial capabilities. The ineffective management of expansion in the business could have a material adverse effect on our business, results of operations and financial condition.

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 also depends in significant part upon the continued service of our key technical and senior management personnel, many of whom have been with the Company for a significant period of time. We maintain term key man life insurance policy for the CEO, and do not maintain key man life insurance on any other of our employees. Because we have a relatively small number of employees when compared to other leading 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 healthcare and motion control industries. 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 grant additional stock options to key employees and provide other forms of incentive compensation to attract and retain such key personnel.

Our products may be subject to product liability legal claims which may cost us significant amounts in both money and management time and resources.

We maintain insurance to protect against claims associated with the use of our products, but there can be no assurance that our insurance coverage would adequately cover any claim asserted against us. A successful claim brought against us in excess of our insurance coverage could have a material adverse effect on our business, results of operations and financial condition. Even unsuccessful claims could result in the expenditure of funds in litigation and management time and resources.

There can be no assurance that we will not be subject to product liability claims, that such claims will 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. Such claims could have a material adverse affect on our business, results of operations and financial condition.

Our evaluation of internal control and remediation of potential problems will be costly and time consuming and could expose weaknesses in financial reporting.

The regulations implementing Section 404 of the Sarbanes-Oxley Act of 2002 require management's assessment of the effectiveness of the Company's internal control over financial reporting beginning with our Annual Report on Form 10-KSB for the fiscal year ending June 30, 2008. Our independent auditors will be required to confirm in writing whether management's assessment of the effectiveness of the internal control over financial reporting is fairly stated in all material respects, and separately report on whether they believe management maintained, in all material respects, effective internal control over financial reporting as of June 30, 2008. This process will be expensive and time consuming, and will require 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, costly and 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.

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 matters that govern the measurement of our performance. Based on our reading and interpretations of relevant guidance, principles or concepts issued by, among other authorities, the American Institute of Certified Public Accountants, the Financial Accounting Standards Board, and the United States Securities and Exchange Commission, our management believes our current sales contract terms and business arrangements have been properly reported. However, there