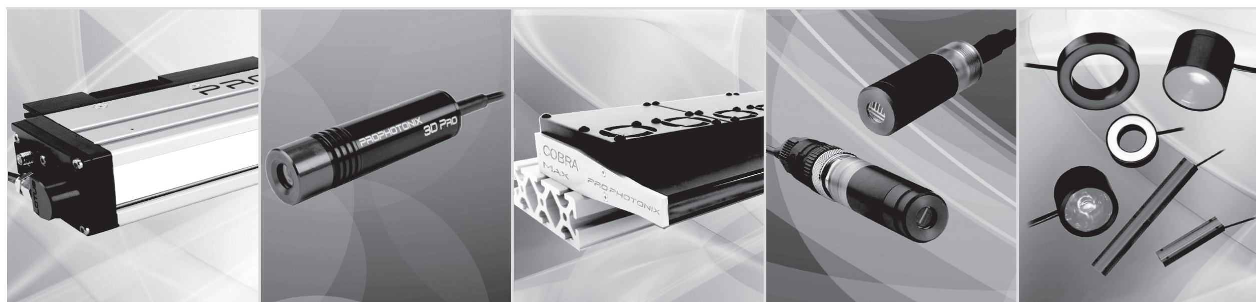
PROPHOTONIX LIMITED
2012 ANNUAL REPORT



Solutions for LEDs

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Solutions for Lasers

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Corporate

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2012 Annual Report to Stockholders

Dear Fellow Stockholders:

ProPhotonix's 2012 financial results were disappointing. Enough has been written of the collapse in business associated with the solar industry, to which we were deeply tethered in 2011, and which created much of the negative effect on our business in 2012. Sales to the solar industry in 2011 were 15% of revenue, however, this declined to only 2% of sales in 2012. The effect of this shift resulted in the decline in revenue and gross profit, and coupled with the investment in the expanded sales force contributed to an operating loss of $3.1 million in 2012. Honestly speaking we made mistakes: first, we did not sufficiently diversify our customer and market positions, a situation of which we are mindful, and second, we did not reap the rewards from the expected uptake in revenue from our investments in the expanded sales force. However, the benefits of the sales force investment are becoming visible in 2013 as discussed below.

While the 2012 financial results were dissatisfying, the operations had many accomplishments. Enhancements were made to most of the LED product lines and several new LED and laser products introduced: (i) the Cobra Max line light delivering up to twice the intensity of the COBRA Slim series for line scan applications, the highest intensity line light on the market, (ii) the LOTUS range was extended, adding two new cooling options to boost intensity, (iii) InViso Micro Laser providing the thinnest line to the machine vision market, and (iv) the introduction of the newest structured light laser family, 3D Pro and 3D Pro Mini, extending our offering to customers with exacting vision inspection laser applications. The Company also expanded its world-wide sales distribution network as envisioned at the beginning of the year. Finally, the year finished with an improving book-to-bill ratio of 1.08 along with signs of continuing improvement.

An improvement of business activity is evident in 2013; order bookings through the first four months totaled $6.2 million and the April 30, 2013 backlog of unshipped orders grew 25% since December 31, 2012. The recent order activity is validation of the investment in the sales organization that began in 2011, as a significant amount of these orders are from new customers we initially engaged with in late 2011 and 2012.

Many positive changes are occurring within our Company. Early in 2013, ProPhotonix expanded its distributed product portfolio. The portfolio now includes high powered laser devices from Oclaro, augmenting a multi-year relationship between our companies. In addition, the Company and Osram Opto Semiconductors embraced a mutual agreement for ProPhotonix to distribute Osram's ground breaking green and blue Direct Diode Lasers. Both of these arrangements add to our product portfolio further supporting our customers.

Most important, in June 2013 the Company secured new loan financing with net availability of $2.5 million through an existing lender to the Company alongside a new lender. In connection with the financing, the existing lender converted €144,324 ($193,132) of debt into equity. We are confident that this infusion of capital puts ProPhotonix on solid footing to continue the execution of its long term strategy. The loan financing will be used for improving operations, capital investments, product development, and business development.

On May 24, 2013, with the financing substantially in place, Mark W. Blodgett announced his retirement from the Company after 24 years of service. Mr. Dietmar Klenner also announced, in June 2013, that he will not stand for re-election to the Board after 10 years of service. I would like to thank Mr. Blodgett for his leadership and vision and to also thank Mr. Klenner for his service as a Director. On June 25, 2013, Raymond Oglethorpe became Chairman of the Board (a non-executive director) and Mr. Mark Weidman, President, Wheelabrator Technologies, Inc., a subsidiary of Waste Management, Inc., was nominated by our Board for election by our stockholders at our annual meeting of stockholders as non-executive Director to the Board of Directors to fill the vacancy created by Mr. Klenner's decision to not stand for re-election. Mr. Philip Feeley has accepted the position as acting Chief Financial Officer having served as the Corporate Controller since 2005. We continue to strengthen the excellent board governance practices of the Company.

I sincerely thank you: employees, customers, suppliers, and stockholders for your continued support and confidence in ProPhotonix.

Respectfully submitted,

Tim Losik
President and Chief Executive Officer

Director Remuneration Report

For the year ended December 31, 2012

Executive Director Compensation - Executive Director Compensation is reviewed by the Independent Non-Executive Directors.

Non-Executive Director compensation is established periodically.

						Expensed in 2012 based on stock compensation rules, without consideration of forfeitures				
Executive Director	**Salary ($)**	**Bonus ($)**	**Pension ($)**	**Other (1) ($)**	**Total Cash Compensation ($)**	**Options ($)**	**RSA's ($)**	**Total ($)**	**Total All Compensation 2012 ($)**	**Total All Compensation 2011 ($)**
Mark Blodgett (2)	384,000	-	1,875	9,050	394,925	19,779	-	19,779	414,704	446,868
Tim Losik	215,000	-	5,625	750	221,375	9,889	1,047	10,936	232,311	231,905
Total Executive Compensation	**599,000**	**-**	**7,500**	**9,800**	**616,300**	**29,668**	**1,047**	**30,715**	**647,015**	**678,773**
Non-Executive Director										
Dieter Klenner	-	-	-	21,250	21,250	3,488	-	3,488	24,738	31,576
Ray Oglethorpe	-	-	-	21,250	21,250	3,488	-	3,488	24,738	32,636
Timothy Steel	-	-	-	21,250	21,250	3,488	-	3,448	24,738	16,691
Vincent Thompson	-	-	-	21,250	21,250	3,488	-	3,448	24,738	16,691
Total Non-Executive Compensation	**-**	**-**	**-**	**85,000**	**85,000**	**13,954**	**-**	**13,954**	**98,954**	**97,594**

Director Share Options:

Director	Options @ 12/31/11	Options Granted	Options Forfeited	Options @ 12/31/12
Mark Blodgett	3,054,050	1,000,000	(199,400)	3,854,650
Tim Losik	900,000	500,000	-	1,400,000
Dieter Klenner	656,518	250,000	-	906,518
Ray Oglethorpe	757,006	250,000	(11,500)	995,506
Timothy Steel	195,433	250,000	-	445,433
Vincent Thompson	195,433	250,000	-	445,433
Total All Directors	**5,758,440**	**2,500,000**	**(210,900)**	**8,047,540**

(1) Other compensation for Executive Directors is for paid life insurance for the benefit of the director. Other compensation for non-executive directors represents cash payments expensed in the current year.

(2) Excludes company paid housing expenses for Mr. Blodgett in the amount of $108,885 and U.K. income taxes in the amount of $171,546, of which $62,164 related to 2011. As of May 24, 2013, Mr. Blodgett retired from ProPhotonix Limited and as of the date of this report is no longer a director of the Company.

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ProPhotonix Limited

Consolidated Financial Statements

Years Ended December 31, 2012 and 2011

FINANCIAL STATEMENTS

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Independent Auditors’ Report

The Board of Directors
ProPhotonix Limited
32 Hampshire Road
Salem
New Hampshire
United States of America

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of ProPhotonix Limited and its subsidiaries, which comprise the consolidated balance sheet as of December 31, 2012, and the related consolidated statements of operations and comprehensive loss, stockholders’ equity / (deficit), and cash flows for the year then ended, and the related notes to the consolidated financial statements.

Management’s Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors’ Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors’ judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly in all material respects, the financial position of ProPhotonix Limited. and its subsidiaries as of December 31, 2012, and the results of their operations and their cash flows for the year then ended in accordance with U.S. generally accepted accounting principles.

Other matters

The consolidated financial statements of ProPhotonix Limited and its subsidiaries as of and for the year ended December 31, 2011 were audited by other auditors. Those auditors expressed an unqualified opinion on those financial statements in their report dated 11 April 2012.

KpmgLLP

KPMG LLP

Cambridge
United Kingdom

20 June 2013

McGladrey & Pullen, LLP
Certified Public Accountants

Independent Auditor's Report

To the Board of Directors and Stockholders
ProPhotonix Limited
Salem, New Hampshire

We have audited the accompanying consolidated balance sheet of ProPhotonix Limited (formerly known as StockerYale, Inc.) and subsidiaries (the Company) as of December 31, 2011, and the related consolidated statements of operations and comprehensive loss, stockholders' equity (deficit), and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. 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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2011, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

McGladrey & Pullen, LLP

Boston, Massachusetts
April 11, 2012

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Member of RSM International network, a network of independent accounting, tax and consulting firms.

FINANCIAL STATEMENTS

PROPHOTONIX LIMITED

CONSOLIDATED BALANCE SHEETS

($ in thousands except share and per share data)

December 31	**2012**	**2011**
Assets		
Current assets:		
Cash and cash equivalents	$ 1,278	$ 4,066
Accounts receivable, less allowances of $31 in 2012 and $13 in 2011	2,225	2,405
Inventories	2,033	1,694
Prepaid expenses and other current assets	234	288
Total current assets	5,770	8,453
Net property, plant and equipment	523	653
Goodwill	467	458
Acquired intangible assets, net	218	332
Other long-term assets	23	36
Total assets	$ 7,001	$ 9,932
Liabilities and Stockholders' Equity		
Current liabilities:		
Revolving credit facility	$ 662	$ 643
Current portion of long-term debt	2,387	1,587
Capital lease obligations	10	-
Accounts payable	2,000	1,456
Income taxes payable	-	29
Accrued expenses	1,084	778
Total current liabilities	6,143	4,493
Long-term debt, net of current portion	-	1,631
Long-term portion of capital lease obligations	10	-
Other long-term liabilities	178	178
Total liabilities	6,331	6,302
Stockholders' equity:		
Common stock, par value $0.001; shares authorized 150,000,000 at December 31, 2012 and December 31, 2011; 76,059,457 shares issued and outstanding at December 31, 2012 and December 31, 2011	76	76
Paid-in capital	110,893	110,751
Accumulated deficit	(110,521)	(107,618)
Accumulated other comprehensive income	222	421
Total stockholders' equity	670	3,630
Total liabilities and stockholders' equity	$ 7,001	$ 9,932

See the notes to consolidated financial statements.

PROPHOTONIX LIMITED
Consolidated Statements of Operations and Comprehensive Loss
($ in thousands except share and per share data)

	Years Ended December 31,	
	2012	**2011**
Revenue	$ 13,904	$ 16,977
Cost of Revenue	(9,597)	(10,613)
Gross Profit	4,307	6,364
Research & Development Expenses	(922)	(899)
Selling, General & Administrative Expenses	(6,403)	(6,030)
Amortization of Intangible Assets	(118)	(275)
Operating Loss	(3,136)	(840)
Other Income / (Expense), net	490	(184)
Interest Expense	(257)	(363)
Loss Before Taxes from Continuing Operations	(2,903)	(1,387)
Tax Provision	-	37
Net Loss from Continuing Operations	(2,903)	(1,424)
Loss from Discontinued Operations, net of tax	-	(19)
Net Loss	$ (2,903)	$ (1,443)
Other Comprehensive Income (Loss):		
Foreign currency translation	(199)	165
Total Comprehensive Loss	$ (3,102)	$ (1,278)
Loss Per Share:		
Basic and diluted:		
Net loss from continuing operations	($0.04)	($0.02)
Loss from discontinued operations, net	($0.00)	($0.00)
Net loss per share	($0.04)	($0.02)
Basic and diluted weighted average shares outstanding	76,059,457	63,485,600

See the notes to consolidated financial statements.

PROPHOTONIX LIMITED

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY / (DEFICIT)

(in thousands)

	Common Stock					
	Shares	Par $0.001	Paid in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income	Total Stockholders' Equity (Deficit)
Balance December 31, 2010	52,510	$ 53	$105,678	$ (106,175)	$ 256	$ (188)
Sale of common stock, net of expenses of $350	23,550	23	4,874	-	-	4,897
Share based compensation, net of forfeitures	-	-	199	-	-	199
Translation adjustment					165	165
Net loss.............................				(1,443)		(1,443)
Balance December 31, 2011	76,060	$ 76	$110,751	$ (107,618)	$ 421	$ 3,630
Share based compensation, net of forfeitures	-	-	143	-	-	143
Translation adjustment					(199)	(199)
Net loss.............................				(2,903)		(2,903)
Balance December 31, 2012	76,060	$ 76	$110,893	$ (110,521)	$ 222	$ 670

See the notes to consolidated financial statements.

PROPHOTONIX LIMITED

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

Years Ended December 31	**2012**	**2011**
Operating		
Net loss	$ (2,903)	$ (1,443)
Loss from discontinued operations, net of tax	-	(19)
Net loss from continuing operations	**(2,903)**	**(1,424)**
Adjustments to reconcile net loss to net cash used in operating activities:		
Stock-based compensation expense	143	199
Depreciation and amortization	396	601
Foreign exchange (gain) loss	(188)	281
Loss on disposal of assets	-	8
Provision for inventories	75	61
Provision for bad debts	25	-
Other changes in assets and liabilities:		
Accounts receivable	199	(567)
Inventories	(372)	100
Prepaid expenses and other current assets	57	(1)
Accounts payable	505	(529)
Income taxes payable	-	29
Accrued expenses	261	(584)
Other assets and liabilities	21	29
Net cash used in continuing operations	**(1,782)**	**(1,797)**
Net cash used in discontinued operations	-	(19)
Net cash used in operating activities	**(1,782)**	**(1,816)**
Investing		
Purchase of property, plant and equipment	(67)	(95)
Net cash used in investing activities	**(67)**	**(95)**
Financing		
Net proceeds from sale of common stock	-	4,897
Borrowings of revolving credit facilities, net	-	8
Principal repayment of long-term debt	(889)	(753)
Net cash provided by (used in) financing activities	**(889)**	**4,152**
Effect of exchange rate on cash	(50)	14
Net change in cash and equivalents	(2,788)	2,255
Cash and equivalents at beginning of period	4,066	1,811
Cash and equivalents at end of period	**$ 1,278**	**$ 4,066**
Supplemental cash flow information:		
Cash paid for interest	$ 228	$ 363
Cash paid for income tax	$ -	$ 15

See the notes to consolidated financial statements.

PROPHOTONIX LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) ORGANIZATION AND BASIS OF PRESENTATION

ProPhotonix Limited (also referred to in this document as "ProPhotonix", "we", or the "Company") operates in two segments: as an independent designer and manufacturer of LED systems through ProPhotonix (IRL) Limited; and as a distributor of laser diodes and manufacturer of laser modules through ProPhotonix Limited, a U.K. subsidiary. The operating units are ProPhotonix (IRL) Limited based in Cork, Ireland, ProPhotonix Limited, a U.K. subsidiary based near Stansted, United Kingdom and ProPhotonix Limited, based in Salem, New Hampshire, U.S.A. The Company's products serve a wide range of applications and industries including machine vision and industrial inspection, biomedical, defense and security, and other commercial applications.

ProPhotonix Limited was incorporated on March 27, 1951 in the Commonwealth of Massachusetts and currently incorporated in the state of Delaware. The common stock of the Company now trades on the Pink OTC Market in the U.S. under the trading symbol "STKR". On December 23, 2010, the Company gained admission to the London Stock Exchange, plc (AIM listing), under the trading symbols "PPIR" and "PPIX".

The accompanying consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. As shown in the consolidated financial statements, during the years ended December 31, 2012 and 2011, the Company recorded net losses of $2,903,000 and $1,443,000, respectively. Net use of cash flow for operating activities from continuing operations for the same time periods were $1,782,000 and $1,797,000, respectively. The consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts and classification of liabilities that might be necessary should the Company be unable to continue as a going concern. On June 20, 2013, the Company entered into an amendment with the PPI Bond bondholder who waived any and all events of default and to amend the terms of the PPI Bond. The amendment restructures the existing Bond as described in Note 8. Also on June 20, 2013, the Company entered into a term note agreement with the holder of the PPI Bond allowing for an additional $1,000,000 of available funds as described in Note 17. Under the terms of this note, the Company must use 50% of any amounts advanced to make additional principal payments under the PPI Bond. Finally, on June 20, 2013, The Company entered into a term note agreement with a Lender, affiliated with the Company CEO, for $2.0 million of available funds as described in Note 17. The Company believes with this loan capacity that it has adequate working capital to continue to trade for at least the next twelve months from the approval of these financial statements.

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying consolidated financial statements are prepared in conformity with Generally Accepted Accounting Principles ("U.S. GAAP") and reflect the application of the Company's most significant accounting policies as described in this note and elsewhere in the accompanying consolidated financial statements and notes.

PRINCIPLES OF CONSOLIDATION

The accompanying consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, ProPhotonix (IRL) Limited, StockerYale Waterloo Acquisition Inc., StockerYale (UK) Ltd., which owns 100% of ProPhotonix Limited, a U.K. subsidiary, and ProPhotonix Holdings, Inc., which

holds all of the outstanding shares of StockerYale Canada (see note 14 for more information on the sale of the assets of StockerYale Canada). All intercompany balances and transactions have been eliminated.

CASH AND CASH EQUIVALENTS

The Company considers cash equivalents to consist of highly liquid investments with original maturities of three months or less when purchased.

ACCOUNTS RECEIVABLE

The Company reviews the financial condition of new customers prior to granting credit. After completing the credit review, the Company establishes a credit line for each customer. Periodically, the Company reviews the credit line for major customers and adjusts the credit limit based upon an updated financial condition of the customer, historical sales and payment information and expected future sales. The Company has a large number of customers; therefore, material credit risk is limited.

The Company periodically reviews the collectability of its accounts receivable. Provisions are established for accounts that are potentially uncollectible. The Company also has receivables insurance at ProPhotonix Limited, a U.K. subsidiary, which allows the Company to submit a claim on overdue receivables in excess of 60 days past invoice date. Determining adequate reserves for accounts receivable requires management's judgment. Conditions impacting the collectability of the Company's receivables could change causing actual write-offs to be materially different than the reserved balances.

Changes in the allowance for doubtful accounts were as follows:

Years Ended December 31	**2012**	**2011**
	In thousands	
Balance at beginning of period	$ 13	$ 47
Charges to costs and expenses	25	-
Account write-offs and other deductions	(7)	(34)
Balance at end of period	$ 31	$ 13

INVENTORY

The Company values inventories at the lower of cost or market using the first in, first-out ("FIFO") method. The Company periodically reviews the quantities of inventory on hand and compares these amounts to the expected usage for each particular product or product line. The Company records as a charge to cost of sales any amounts required to reduce the carrying value amount of the inventory to net realizable value. Actual results could be different from management's estimates and assumptions.

INTANGIBLE ASSETS

The Company's intangible assets consist of goodwill, trademarks, acquired patents and patented technologies, distributor and customer relationships and related contracts, technology design and programs, non-compete agreements and other intangible assets which, except for goodwill, are being amortized over their useful lives. Goodwill is tested for impairment on an annual basis, and between annual tests in certain circumstances, and written down when and if impaired. The Company has elected the end of the fourth quarter to complete its annual goodwill impairment test.

LONG-LIVED ASSETS

The Company reviews the recoverability of its long-lived assets including property, plant and equipment and amortizing intangible assets when events or changes in circumstances occur that indicate that the carrying value of the assets may not be recoverable. This review is based on the Company's ability to recover the carrying value of the assets from expected undiscounted future cash flows. If impairment is indicated, the Company measures the loss based on the difference between the carrying value and fair value of the asset using various valuation techniques including discounted cash flows. If an impairment loss exists, the amount of the loss will be recorded in the consolidated statements of operations. It is possible that future events or circumstances could cause these estimates to change.

LOSS PER SHARE

The Company calculates basic and diluted net loss per common share by dividing the net loss applicable to common stockholders by the weighted average number of common shares outstanding.

As of December 31, 2012, 9,355,890 shares underlying options and 7,809,567 shares underlying warrants were excluded from the calculation of diluted shares, as their effects were anti-dilutive.

As of December 31, 2011, 6,567,940 shares underlying options and 7,828,188 shares underlying warrants were excluded from the calculation of diluted shares, as their effects were anti-dilutive.

REVENUE RECOGNITION

The Company recognizes revenue from product sales at the time of shipment and when persuasive evidence of an arrangement exists, performance of our obligation is complete, the price to the buyer is fixed or determinable, and collectability is reasonably assured. Custom products are designed and supplied to original equipment manufacturers and produced in accordance with a customer-approved design. Custom product revenue is recognized when the criteria for acceptance has been met. Title to the product generally passes upon shipment, as products are generally shipped freight on board (FOB) at shipping point. In certain limited situations, distributors may have the right to return products. Such rights of return may preclude the Company from recognizing revenue until the return period has ended.

Revenues from funded research and development and product development are recognized based on contractual arrangements, which may be based on cost reimbursement or fixed fee-for-service models. Revenue from reimbursement contracts is recognized as services are performed. On fixed-price contracts, revenue is generally recognized on a percentage of completion basis based on proportion of costs incurred to the total estimated costs of the contract or under the proportional method. Over the course of a fixed-price contract, the Company routinely evaluates whether revenue and profitability should be recognized in the current period. The Company estimates the proportional performance on their fixed-price contracts on a monthly basis utilizing hours incurred to date as a percentage of total estimated hours to complete the project. If the Company does not have a sufficient basis to measure progress toward completion, revenue is recognized upon completion of performance, subject to any project management assessments as to the status of work performed. This method is used because reasonably dependable estimates of costs and revenue earned can be made based on historical experience and milestones identified in any particular contract. When the current estimates of total contract revenue and contract costs indicate a loss, a provision for the entire loss on the contract is recorded.

The FASB issued amended revenue recognition guidance for arrangements with multiple deliverables under the FASB Accounting Standards Update ("ASU") 2009-13, *Multiple-Deliverable Revenue Arrangements* ("ASU 2009-13"). ASU 2009-13 is effective in fiscal years beginning on or after June 15, 2010, with early adoption permitted. The Company adopted the guidance effective January 1, 2011.

For those arrangements that include multiple deliverables, the Company first determines whether each service or deliverable meets the separation criteria of FASB ASC 605-25, *Revenue Recognition—Multiple-Element Arrangements*. In general, a deliverable (or a group of deliverables) meets the separation criteria if the deliverable has stand-alone value to the customer and, if the arrangement includes a general right of return related to the delivered item, that delivery or performance of the undelivered item(s) is considered probable and is substantially in control of the Company. Each deliverable that meets the separation criteria is considered a separate ‘‘unit of accounting”. After the arrangement consideration has been allocated to each unit of accounting, the Company applies the appropriate revenue recognition method for each unit of accounting based on the nature of the arrangement and the services included in each unit of accounting. All deliverables that do not meet the separation criteria of FASB ASC 605-25 are combined into one unit of accounting, and the most appropriate revenue recognition method is applied.

WARRANTY

The Company provides standard warranties for most products for periods up to one year. The warranty is limited to the cost of the product and the Company will repair or replace the product as required. The Company monitors the actual warranty repair costs and trends in relation to the reserve as a percent of sales. The Company adjusts annually the warranty provision based on actual experience and for any particular known instances.

Warranty Reserves:

	Years Ended December 31,	
	2012	**2011**
	In thousands	
Balance at beginning of period	$ 159	$ 155
Charges to costs and expenses	18	39
Account write-offs and other deductions	(13)	(35)
Balance at end of period	$ 164	$ 159

ADVERTISING EXPENSE

The Company expenses advertising costs as incurred. Advertising expenses for the years ended 2012 and 2011 were approximately $250,000 and $330,000, respectively.

PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment are valued at the lower of cost or estimated carrying values. The Company provides for depreciation on a straight-line basis over the assets estimated useful lives or capital lease terms, if shorter. The following table summarizes the estimated useful lives by asset classification:

Asset Classification	Estimated Useful Life
Building and building improvements	Term of the lease or 10-40 years
Computer equipment	3 to 5 years
Machinery and equipment	5 to 10 years
Furniture and fixtures	3 to 10 years

Maintenance and repairs are expensed as incurred.

INCOME TAXES

The Company accounts for income taxes under the liability method. Under this method the Company recognizes deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in the financial statements or tax returns. Deferred tax assets and liabilities are determined based on the difference between the financial reporting and tax basis of the assets and liabilities using tax rates expected to be in place when the differences reverse. Valuation allowances are established when necessary to reduce deferred tax assets to the amount that is more likely than not to be realized. The Company recognizes the tax benefit of tax positions to the extent that the benefit will more likely than not be realized. The determination as to whether the tax benefit will more likely than not be realized is based upon the technical merits of the tax position as well as consideration of the available facts and circumstances. With respect to any uncertain tax positions, the Company records interest and penalties, if any, as a component of income tax expense. It did not have any interest and penalties related to uncertain tax positions during the years ended December 31, 2012 or 2011. As of December 31, 2012 and 2011, the Company has cumulatively recorded long-term liabilities of $178,000 and $178,000 respectively, relative to the sale of its North American operations to Coherent, Inc. Additional information on the Company's income tax provision and deferred tax assets and liabilities may be found at Note 9.

STOCK-BASED COMPENSATION

The Company has stock-based compensation plans for its employees, officers, and directors. The plans permit the grant of a variety of awards with various terms and prices as determined by the Remuneration Committee of the Company's Board of Directors ("GNRC"). Generally the grants vest over terms of two to four years and are priced at fair market value, or in certain circumstances 110% of the fair market value, of the common stock on the date of the grant. The options are generally exercisable after the period or periods specified in the option agreement, but no option may be exercised after 10 years from the date of grant.

Additionally, in the case of incentive stock options, the exercise price may not be less than 100% of the fair market value of the Company's common stock on the date of grant, except in the case of a grant to an employee who owns or controls more than 10% of the combined voting power of all classes of the Company's stock or the stock of any parent or subsidiary. In that case, the exercise price shall not be less than 110% of the fair market value on the date of grant. In the case of non-qualified stock options, the exercise price shall not be less than 85% of the fair market value of the Company's common stock on the date of grant, except in the case of a grant to an independent director; in which case the exercise price shall be equal to fair market value determined by reference to market quotations on the date of grant.

During 2012, the Company recognized approximately $143,000 of stock-based compensation related to restricted stock and options, all of which was charged to administrative expense. During 2011, the Company recognized approximately $199,000 of stock-based compensation related to restricted stock and options, all of which was charged to selling, general and administrative expense.

Stock Option Awards—The fair value of each option grant is estimated using the Black-Scholes option pricing model. The fair value is then expensed ratably over the requisite service periods of the awards, which is generally the vesting period. Use of a valuation model requires management to make certain assumptions with respect to selected model inputs. Expected volatility is calculated based on the historical volatility of the Company's stock at the time of the award. The average expected option term is based on historical trends. The risk-free interest rate is based on U.S. Treasury zero-coupon issues assumed at the date of grant and generally no dividends are assumed in the calculation. The compensation expense recognized for all equity-based awards is net of estimated forfeitures. Forfeitures are estimated based on the historical trends.

Restricted Share Awards— The Company periodically awards restricted shares of common stock to employees. The awards vest in equal annual installments over a period of four years, assuming continued employment, with some exceptions. The fair market value of the award at the time of the grant is amortized over the vesting period. The fair value of the awards is based on the fair market value of the Company's common stock on the date of issue, which is the closing market price on the date of the award. During 2012 and 2011, the Company did not grant any shares of restricted stock.

TRANSLATION OF FOREIGN CURRENCIES

The Company's operating results are affected by fluctuations in the value of the U.S. dollar as compared to currencies in foreign countries, as a result of our transactions in these foreign markets. For foreign subsidiaries, whose functional currency is not the U.S. dollar, assets and liabilities are translated using the foreign exchange rates prevailing at the balance sheet date, and income and expense accounts using average exchange rates for the period. Cumulative transaction gains or losses from the translation into the Company's reporting currency are included as a separate component of stockholder's equity (accumulated other comprehensive loss) in the accompanying consolidated balance sheets.

Management has determined the functional currency of StockerYale (UK) Ltd, and ProPhotonix Limited, a U.K. subsidiary, is the euro. The functional currency of ProPhotonix (IRL) Limited is the euro, while the functional currency of ProPhotonix Limited U.S.A. is the U.S. dollar.

Foreign currency transaction losses from continuing operations recorded in the statements of operations as other income (expense), net were approximately $(471,000) and $327,000 for 2012 and 2011, respectively.

FAIR VALUES OF FINANCIAL INSTRUMENTS

The Company's financial instruments consist mainly of cash and cash equivalents, accounts receivable, revolving credit facility, accounts payable and long-term debt. The estimated fair value of these financial instruments, with the exception of fixed rate long-term debt, approximates their carrying value due to the short-term maturity of certain instruments and the variable interest rates associated with certain instruments, which have the effect of re-pricing such instruments regularly. The carrying value of fixed rate long-term debt approximates fair value.

CONCENTRATION OF CREDIT RISK

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of trade receivables. The risk is limited due to the relatively large number of customers composing the Company's customer base and their dispersion across many industries and geographic areas within the United States, Canada, United Kingdom, Europe and Asia. The Company performs ongoing credit evaluations of existing customers' financial condition. The Company believes that its concentrated credit risk is limited to only a small number of customers. The Company had no customer accounting for 10% or more of consolidated revenues in either 2012 or 2011. The Company had one customer that accounted for 10% of the outstanding accounts receivable balance at December 31, 2012 and 2011. The Company maintains its cash and cash equivalents in bank deposit accounts, which at times may exceed insured limits. At December 31, 2012, the amount in excess of governmental insurance protection was approximately $1.0 million. At December 31, 2011, the amount in excess of governmental insurance protection was approximately $3.7 million. The Company believes it is not exposed to any significant credit risk on cash and cash equivalents.

USE OF ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements and the reported amounts of income and expenses during the reporting periods. Actual results in the future could vary from the amounts derived from management's estimates and assumptions.

(3) RECENT ACCOUNTING PRONOUNCEMENTS

In May 2011, the FASB issued Accounting Standards Update (ASU) 2011-04, "Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and International Financial Reporting Standards (IFRS)." ASU 2011-04 represents converged guidance between GAAP and IFRS resulting in common requirements for measuring fair value and for disclosing information about fair value measurements. This new guidance is effective for fiscal years beginning after December 15, 2011 and subsequent interim periods. The requirements of ASU 2011-04 did not have a material impact on the Company's Consolidated Financial Statements.

In June 2011, the FASB issued ASU 2011-05, "Presentation of Comprehensive Income." ASU 2011-05 requires the Company to present components of other comprehensive income and of net income in one continuous statement of comprehensive income, or in two separate, but consecutive statements. The option to report other comprehensive income within the statement of equity has been removed. This new presentation of comprehensive income is effective for fiscal years beginning after December 15, 2011 and subsequent interim periods. As this standard relates only to the presentation of other comprehensive income, the adoption of the accounting standard did not have an impact on our consolidated financial position, results of operations and cash flows. The revised presentation requirements are reflected in the Consolidated Statements of Comprehensive Income.

In September 2011, the FASB issued ASU 2011-08, "Testing Goodwill for Impairment." This revised standard provides entities with the option to first use an assessment of qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If a conclusion is reached that reporting unit fair value is not more likely than not below carrying value, no further impairment testing is necessary. This revised guidance applies to fiscal years beginning after December 15, 2011, and the related interim and annual goodwill impairment tests. The requirements of ASU 2011-08 did not have an impact on the Company's Consolidated Financial Statements.

In December 2011, the FASB issued ASU 2011-11, "Disclosures about Offsetting Assets and Liabilities." ASU 2011-11 requires enhanced disclosures including both gross and net information about financial and derivative instruments eligible for offset or subject to an enforceable master netting arrangement or similar agreement. This new guidance is effective for annual reporting periods beginning on or after January 1, 2013 and subsequent interim periods. The requirements of ASU 2011-11 will not have an impact on the Consolidated Financial Statements.

(4) INVENTORIES

Inventories are stated at the lower of cost (first-in, first-out basis) or market when applicable and include materials, labor and overhead. Inventories are as follows:

Years Ended December 31	**2012**	**2011**
	In thousands	
Finished goods	$ 460	$ 362
Work in-process	176	141
Raw materials	1,397	1,191
Net inventories	$ 2,033	$ 1,694

Management performs quarterly reviews of inventory and disposes of items not required by their manufacturing plan and reduces the carrying cost of inventory to the lower of cost or market.

(5) PROPERTY, PLANT AND EQUIPMENT

Major classes of property, plant and equipment were as follows:

Years Ended December 31	**2012**	**2011**
	In thousands	
Buildings and building improvements	$ 290	$ 284
Computer equipment	427	414
Machinery and equipment	1,785	1,738
Furniture and fixtures	703	622
Property, plant and equipment	$ 3,205	$ 3,058
Less accumulated depreciation	(2,682)	(2,405)
Net property, plant and equipment	$ 523	$ 653

Depreciation expense from continuing operations was approximately $278,000 and $326,000 in the years ended December 31, 2012 and 2011, respectively.

(6) GOODWILL

The Company uses a three-step approach to a goodwill impairment test. First, ASU 2011-08 allows entities with the option to first use an assessment of qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If a conclusion is reached that reporting unit fair value is not more likely than not below carrying value, no further impairment testing is necessary. If further testing is necessary, the second step is to estimate the fair value of its reporting units by using forecasts of discounted cash flows and compare that value to the carrying value which requires that certain assumptions and estimates be made regarding industry economic factors and future profitability of reporting units to assess the need for an impairment charge. The methodology the Company uses to allocate certain corporate expenses is based on each segments use of services and/or direct benefit to its employees. While the Company believes it has made reasonable estimates and assumptions to calculate the fair value of the reporting segments and implied fair value of goodwill, the impairment analysis is highly sensitive to actual versus forecast results. If the estimated value is less than the carrying value the Company moves to the third step of the impairment test to determine if goodwill is impaired.

In connection with the annual fair value test of goodwill, performed at the end of the fourth quarter 2012, and at the end of the fourth quarter 2011, the Company concluded that no impairment existed.

The changes in the carrying amount of goodwill for the years ended December 31, 2012 and 2011 was as follows:

	December 31, 2012	December 31, 2011
	(In thousands)	
Beginning of the year	$ 458	$ 468
Effect of exchange rate	9	(10)
End of year	$ 467	$ 458

Goodwill as of December 31, 2012 and 2011 relates to the LED reporting unit.

(7) INTANGIBLE ASSETS

Intangible assets consist of distributor and customer relationships and related contracts, technology design and programs, and other intangible assets. There are no intangible assets with indefinite lives. There were no intangible assets acquired in 2012. Intangible assets and their respective useful lives are as follows:

	Useful Life
Acquired customer contracts and relationships	5 – 8 Years
Acquired technology design and programs	8 Years
Other	3 – 7 Years

Gross carrying amounts and accumulated amortization of intangible assets were as follows as of December 31, 2012 for each intangible asset class.

	Gross Carrying Amount	Accumulated Amortization	Net Balances
		(in thousands)	
Acquired customer contracts and relationships	2,061	(1,935)	126
Acquired technology design and programs	349	(257)	92
Other	114	(114)	-
Total	$ 2,524	$ (2,306)	$ 218

Gross carrying amounts and accumulated amortization of intangible assets were as follows as of December 31, 2011 for each intangible asset class.

	Gross Carrying Amount	Accumulated Amortization	Net Balances
		(in thousands)	
Acquired customer contracts and relationships	1,900	(1,682)	218
Acquired technology design and programs	322	(212)	110
Other	105	(101)	4
Total	$ 2,327	$ (1,995)	$ 332

	Actual Expense		Estimated Future Expense	
	2011	2012	2013	2014
			In thousands	
Amortization expense of intangible assets	$ 275	$ 118	$ 128	$ 90

(8) DEBT

Years Ended December 31	2012	2011
	In thousands	
Bonds payable to the former stockholders of Photonic Products Ltd. maturing on December 31, 2012 (see notes below relative to a default), with an interest rate of 11%, at December 31, 2012 and at December 31, 2011.	$ 243	$ 793
Senior Fixed Rate Secured Bond to a private investor, maturing on June 30, 2015 (see notes below relative to a default), with an interest rate of 8% at December 31, 2012 and at December 31, 2011.	$ 2,144	$ 2,425
Borrowings under Revolving Credit facility with Barclays Bank Sales Financing with an interest rate of 2.65% above Barclay's base rate (3.15% as of December 31, 2012 and 2011).	662	643
Sub-total debt	3,049	3,861
Less – revolving credit facility	(662)	(643)
Less—Current portion of long-term debt	(2,387)	(1,587)
Total long-term debt	$ -	$ 1,631

BORROWING AGREEMENTS

Photonic Products Ltd.

StockerYale (UK) Ltd., a wholly owned subsidiary of the Company, issued bonds to each of the former stockholders of Photonic Products Ltd. with an aggregate initial principal amount equal to $2,400,000 (Photonic Bonds).

On October 30, 2010 and December 10, 2010, the Company and the holders of the Photonic Bonds entered into Deeds of Variation of the Photonic Bonds. The amendments required a payment on October 30, 2010 against the principal balance in the amount of $150,000. The Photonic Bonds were amended to pay the outstanding balance as of October 31, 2010 monthly over the period from November 30, 2010 through November 30, 2012 at the rate of $50,000 principal plus simple interest (at 11% per annum). On December 31, 2012, the remaining balance (approximately $243,000) of the Photonic Bonds was to have been paid in full. However, the Company was in default of payment of the bond at December 31, 2012. The Bond was subsequently paid in full on April 30, 2013.

The original key repayment terms of the Photonic Bonds, under this amendment, were as follows:

(a) Principal as of December 10, 2010:	$1,443,000
(b) Interest Rate:	11% per annum, payable monthly
(c) Repayment term:	October 31, 2010 to November 30, 2012
(d) Monthly principal:	$50,000
(e) Balloon payment:	$243,000 due December 31, 2012

StockerYale (UK) Ltd. could have elected to prepay the bonds at any time, in whole or in part, without penalty or premium. If StockerYale (UK) Ltd. failed to make any payments under the bonds, the former stockholders of Photonic Products Ltd. may have had the right to require payment from the Company in the form of newly issued shares of the Company's common stock.

As of December 31, 2012, $243,000 was outstanding under the bonds issued to the stockholders of Photonic Products Ltd., which was classified as current portion of long-term debt. The bonds were not paid in full on December 31, 2012 as required by the Bond agreement. However, on April 30, 2013, the bonds were paid in full satisfaction of the outstanding amount.

As of December 31, 2011, $793,000 was outstanding under the bonds issued to the stockholders of Photonic Products Ltd., which was classified as current portion of long-term debt

Private Investor Notes and Bond

ProPhotonix (IRL) Limited Senior Fixed Rate Secured Bond

On July 24, 2008, ProPhotonix (IRL) Limited issued a three-year 12% Senior Fixed Rate Secured Bond ("PPI Bond"), as amended at various times, to a bondholder in the original principal amount of €935,000 ($1,472,905 at July 24, 2008) secured by all of the assets of ProPhotonix (IRL) Limited. On June 9, 2009, the bondholder loaned the company an additional $500,000 payable over the remaining term of the original loan, at the same fixed 12% interest rate. Also on June 9, 2009, the Company and bondholder consolidated $1.0 million of other bonds between the Company and bondholder to the PPI Bond.

On December 10, 2010, the Company and the bondholder entered into the most recent amendment of the PPI Bond. The PPI Bond was amended such that interest only is paid monthly on the outstanding balance through June 30, 2012 and thereafter equal monthly payments of principal and interest over the three year period July 1, 2012 through June 30, 2015. The Company also paid a restructuring fee of $50,000 to the bondholder. The key repayment terms of the PPI Bond, under the December, 2010 amendment, are as follows:

(a) Principal as of December 10, 2010:	€1,972,523 ($2,614,000)
(b) Interest Rate:	8% per annum
(c) Interest payments only:	through June 30, 2012
(d) Principal Repayment term:	36 months (July 31, 2012 through June 30, 2015)
(e) Monthly principal and interest:	€61,812 ($82,000)

At December 31, 2012, $2,143,803 was outstanding under the bond all of which was classified as current portion of long-term debt. The Company was in default in respect of its repayment obligations under the bond at December 31, 2012. On June 20, 2013 the bondholder entered into an amendment and waiver agreement with the Company waiving all events of default from inception of the bond through the date of the amendment. In addition, the bondholder also agreed to a restructuring of the bond as follows:

(a) Convert € 144,324 ($193,132) of the balance of the bond into common stock of the Company with a subsequent transfer of such common stock to the Term Loan holder described in Note 17 as part of the Term Loan provided to the Company

(b) Principal as of June 20, 2013: € 1,426,540 ($1,909,281)

(c) Interest Rate: 8% per annum

(d) Interest payments only: June 30, 2013 through June 30, 2014

(e) Principal Repayment: €15,000 per month plus interest July 1, 2014 through June 30, 2015, thereafter principal and interest monthly €56,378 ($75,456) from July 1, 2015 through June 30, 2017*

(f) One-time fee of €31,413 ($42,043) payable on June 30, 2017.

* In addition to the terms above, the bondholder will be entitled to a principal reduction, at the backend of the Bond, equal to 30% of Free Cash Flow defined as (earnings before interest, taxes, depreciation, and amortization (EBITDA) minus debt repaid and interest paid, minus capital expenditures not financed, and minus taxes paid, each during such calendar quarter).

At December 31, 2011, $2,424,917 remained outstanding under the note, which was classified as $794,027 current portion of long-term debt and $1,630,890 as long term debt.

Barclays Bank, PLC

On February 6, 2008, ProPhotonix Limited, a U.K. subsidiary, entered into a Confidential Invoice Discounting Agreement with Barclays Bank Sales Financing (“Barclays”). Under the Discounting Agreement, a three-year revolving line of credit was established. The Discounting Agreement originally provided for a revolving line of credit not to exceed an aggregate principal amount of £700,000 ($1,132,000) and grants a security interest in and lien upon all of ProPhotonix Limited, a U.K. subsidiary, trade receivables in favor of Barclays. The Company originally could borrow a total amount at any given time up to £700,000, limited to qualifying receivables as defined. The proceeds from this line of credit were used to pay in full the outstanding amount under the overdraft facility between ProPhotonix Limited, a U.K. subsidiary, and Barclays Bank, PLC.

The facility requires the maintenance of certain financial covenants including a minimum tangible net worth. On March 8, 2010, the Company entered into an amendment to the revolving credit facility agreement, which temporarily removed the minimum tangible net worth requirement of £350,000 ($566,000 USD as of December 31, 2012) as of March 31, 2010 and June 30, 2010. Barclays also reserves the right to review the facility in the event of losses in any 3-month rolling period at ProPhotonix Limited, a U.K. subsidiary. The maximum amount allowed outstanding under the line of credit is £650,000 ($1,051,000 USD as of December 31, 2012). The outstanding principal under the note accrues interest at an annual rate of 2.65% above the Barclays base rate. The interest rate was 3.15% as of December 31, 2012.

On November 25, 2010, the Company entered into an amendment to the revolving credit facility agreement to extend the minimum period to May 25, 2012 from the original termination date of February 6, 2011.

On November 14, 2012, the Company entered into an amendment to the revolving credit facility agreement to extend the minimum period to November 14, 2013.

The amount outstanding under the facility was $662,000 as of December 31, 2012 and $643,000 as of December 31, 2011, all of which was classified as a short term debt under revolving credit facility. As of December 31, 2012, the Company had approximately $37,000 available under this facility.

(9) TAXES

The Company had deferred tax assets, before considering the full valuation allowance, totaling approximately $27.7 million as of December 31, 2012 and approximately $30.0 million as of December 31, 2011. Realization of the deferred tax assets is dependent upon the Company's ability to generate sufficient future taxable income and, if necessary, execution of tax planning strategies.

The Company's historical operating losses raise considerable doubt as to when, if ever, any of the deferred tax assets will be realized. As a result, management has provided a valuation allowance for the net deferred tax assets. In the event management determines that sufficient future taxable income may be generated in subsequent periods and the previously recorded valuation allowance is no longer needed, the Company will decrease the valuation allowance by providing an income tax benefit in the period that such a determination is made. Because of its historical operating losses, the Company has not been subject to income taxes since 1996. The Company has recorded a deferred tax asset for one of its non-U.S. subsidiaries related to net operating losses.

The Company is subject to taxation in the U.S., Canada, the United Kingdom, Ireland and various states and local jurisdictions. As a result of the Company's tax loss position, the tax years 2000 through 2012 remain open to examination by the federal and most state tax authorities. In addition, the tax years 2007 through 2012 are open to examination in foreign jurisdictions. As of December 31, 2012, the Company did not have any tax examinations in process.

The components of the provision (benefit) for income taxes of continuing operations are as follows:

Years Ended December 31,

	2012	2011
	In thousands	
Current		
Federal	$ —	$ —
State	—	—
Foreign	—	37
Sub-total	—	37
Deferred		
Federal	—	—
State	—	—
Foreign	—	—
Sub-total	—	—
Total provision (benefit)	$ —	$ 37

The income tax (benefit) / provision included in the accompanying statement of operations are as follows:

Years Ended December 31,

	2012	2011
	In thousands	
Continuing Operations	$ -	$ 37
Discontinued Operations	-	28
Total	$ -	$ 65

The significant items comprising the deferred tax asset and liability at December 31, 2012 and 2011 are as follows:

Years Ended December 31,

	2012	2011
	In Thousands	
Net operating loss carry forwards	$ 25,080	$ 25,397
Foreign net operating loss carry forwards	1,693	3,548
R&D tax credit	525	525
Deferred compensation	222	174
Other	184	160
Valuation allowance	(27,704)	(29,671)
Total	$ -	$ 133
Intangible asset-basis differences	-	(133)
Deferred tax liability, net	$ -	$ -

The Company's deferred tax liability, at December 31, 2011 related to the difference in the basis of its intangible assets acquired in a foreign jurisdiction.

As of December 31, 2012, the Company had United States federal net operating loss carry forwards (NOLs) of approximately $62.7 million (2011: $64.1 million) available to offset future taxable income, if any. These carry forwards expire through 2032 and are subject to review and possible adjustment by the Internal Revenue Service. The Company may be subject to limitations under Section 382 of the Internal Revenue Service Code as a result of changes in ownership. The Company's historical operating losses raise considerable doubt as to when, if ever, any of the deferred tax assets will be realized. As a result, management has provided a full valuation allowance for the net deferred tax assets. At December 31, 2012, the Company also has Canadian federal NOLs of approximately $1.5 million (2011: $2.0 million) available to offset future taxable income, if any. These carry forwards expire through 2031 and are subject to review and possible adjustment by the Canadian Revenue Agency. The Company may be subject to limitations of the use of the Canadian NOLs as a result of changes in ownership. The Company's historical operating losses raise considerable doubt as to when, if ever, any of the deferred tax assets will be realized. As a result, management has provided a full valuation allowance for the net deferred tax assets. At December 31, 2012, the Company also has a United Kingdom NOL of approximately $4.5 million (2011: $3.7m) for which management has provided a full valuation allowance against. The total valuation allowance against deferred tax assets has decreased by $2.0m (2011: increased by $0.5m).

The Company must determine whether it is more-likely-than-not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. A tax position that meets the more-likely-than-not threshold is then measured to determine the amount of benefit to recognize in the financial statements. As of December 31, 2012 and 2011, the Company has cumulatively recorded long-term liabilities of $178,000 and $178,000 respectively, relative to the sale of its North American operations to Coherent, Inc. This represents the only significant uncertain tax position of the Company.

(10) UNREGISTERED SALES OF EQUITY SECURITIES AND WARRANTS

On July 13, 2011, the Company sold approximately 23,250,000 shares of common stock on the London Stock Exchange, AIM listing at a price of £0.14 ($0.22) per share for a total of £3.0 million, net of expenses (approximately $4.9 million).

On June 20, 2013, €144,324 ($193,132) of the PPI Bond (Note 8) was converted in exchange for 7,605,946 shares of common stock of the Company; such shares were issued to the Term Loan holder in partial consideration relating to securing the Term Loan (Note 17). Also on June 20, 2013, the Company issued a Warrant in partial consideration for the Term Loan issued by the PPI Bond holder, described in Note 17. The Warrant for 1,900,000 shares of common stock of the Company is exercisable at a price of $0.03 per share through June 20, 2023.

Warrants

As of December 31, 2012, there were 7,809,567 common shares outstanding warrants with the following exercise prices and expiration dates:

Number of Common Shares Warrants	Exercise Price	Expiration Date
1,127,000	$0.50	2013
5,000	$0.50	2014
551,500	$0.32 –$1.44	2015
3,570,000	$1.15 –$3.12	2016
1,150,000	$0.80 –$1.72	2017
906,067	$0.45 –$0.60	2018
500,000	$0.10 –$0.10	2019
7,809,567		

(11) STOCK OPTION PLANS

Under the Company's 2007 Stock Incentive Plan (the 2007 Plan), the Company may issue options, restricted stock, restricted stock units and other stock-based awards to its employees, officers, directors, consultants and advisors. An aggregate of 5,300,000 shares of the Company's common stock were initially reserved for issuance under the 2007 Plan. In addition, there is an annual increase to the number of shares reserved for issuance under the 2007 Plan equal to the lesser of (i) 1,000,000 shares of common stock, (ii) 5% of the outstanding shares of common stock of the Company, or (iii) an amount determined by the Board of Directors of the Company. On April 17, 2012, the Board of Directors approved amendments No. 2 and No. 3 to the 2007 Stock Incentive Plan. Amendment No. 2 provided for various administrative and updated the definition of "exercise price". Amendment No. 3 increased the stock available for Awards to 11,300,000 shares of common stock; plus an annual increase to be added on the first day of each of the Company's fiscal years during the period beginning in fiscal year 2013 and ending on the second day of fiscal year 2017 equal to the lesser of (i) 2,000,000 shares of common stock, (ii) 5% of the outstanding shares on such date, or (iii) an amount determined by the Board. Also, this amendment provides that the per participant limit increased to 2 million shares per calendar year. As of December 31, 2012, there were 11,300,000 shares reserved for issuance and there were 7,300,000 shares reserved at December 31, 2011. The Company had 1,554,544 shares available under the plan for future grants of options and restricted shares December 31, 2012.

In May, 2012, the Board of Directors approved the Third Amended and Restated Policy Regarding Compensation of Independent Directors, (i) cash compensation is increased from $15,000 to $25,000 per annum paid in arrears each quarter; (ii) the number of shares for the option grant for 2012 only shall be calculated as follows: the lesser of 250,000 option shares or the non-cash component of compensation ($25,000) divided by the mid market price as quoted on LSE – AIM on the date of grant as converted into USD at the closing foreign currency exchange rate. Also, in accordance with the foregoing calculation the 2012 annual stock option grants to non-employee Directors of the Company (the "Annual Grants") to be issued as of the date of this meeting (the "Option Date") shall each be for an option to purchase up to 250,000 shares at a per share exercise price of $0.0924, and that such options shall vest and become exercisable as to 25% of the original number of shares subject to each option on each of the first, second, third and fourth anniversaries of the Option Date, until fully vested on the fourth anniversary of the Option Date.

In May 2004, the Company adopted the 2004 Stock Option and Incentive Plan (the 2004 Option Plan) for the purpose of issuing both Incentive Options and Nonqualified Options to officers, employees and directors of the company. No further grants are allowed under this plan.

In May 2000, the Company adopted the 2000 Stock Option and Incentive Plan for the purpose of issuing both Incentive Options and Nonqualified Options to officers, employees and directors of the Company. No further grants are allowed under this plan.

The following table summarizes information about the stock options outstanding as of December 31, 2012. There is no intrinsic value on the options outstanding at December 31, 2012. The intrinsic value of the options exercisable at December 31, 2011 is approximately $3,000.

During 2012 and 2011, the Remuneration Committee approved various qualified and non-qualified stock option awards to purchase shares of the Company's common stock to various officers, directors and employees. There were 3,085,000 options granted during the year ended December 31, 2012 and 2,549,198 options were granted during the year ended December 31, 2011. These options vest over a four year anniversary of the grant date, provided that the recipient continues to serve the Company in that capacity until each such vesting. The exercise price for these options range from $0.09 to $0.11 per share in 2012, and from $0.09 to $0.21 per share in 2011.

The weighted average assumptions for grants during the years ended December 31, 2012 and December 31, 2011 used in the Black-Scholes option pricing model were as follows:

	Twelve months Ended December 31, 2012	Twelve months Ended December 31, 2011
Volatility………………………………………..	188.7%-189.6%	162.1%-167.2%
Expected option life……………………………	4.3 years	5.3 years
Interest rate (risk free)………………………….	0.62%-0.93%	1.81%-2.54%
Dividends……………………………………….	$0	$0
Weighted average grant date fair value………...	$0.10	$0.12

	Options Outstanding	Weighted Average Exercise Price per Share ($)	Weighted Average Remaining Contractual Term (in Years)
Balance at December 31, 2010.......................	4,638,408	1.23	7.25
Granted..	2,549,198	0.12	
Exercised..	-	-	
Cancelled..	(619,666)	6.23	
Balance at December 31, 2011.......................	6,567,940	0.33	7.70
Vested and Exercisable at December 31, 2011..	3,383,786	0.52	6.57
Balance at December 31, 2011.......................	6,567,940	0.33	7.70
Granted..	3,085,000	0.10	
Exercised..	-	-	
Cancelled..	(297,050)	2.55	
Balance at December 31, 2012.......................	9,355,890	0.19	7.70
Vested and Exercisable at December 31, 2012..	4,057,031	0.28	6.36
Vested and Expected to Vest at December 31, 2012..	9,135,139	0.19	7.67

Range of Exercise Prices	Options Outstanding	Weighted Average Contractual Life (years)	Weighted Average Exercise Price	Options Exercisable	Weighted Average Exercise Price
$ 0.08 – 0.99	8,972,990	8.0	$ 0.13	3,674,131	$ 0.17
1.00 – 1.99	317,900	1.1	1.25	317,900	1.25
2.00 – 3.99	65,000	1.4	2.06	65,000	2.06
$ 0.08 – 3.99	9,355,890	7.7	$ 0.19	4,057,031	$ 0.28

At December 31, 2012, there was approximately $414,000 of total unrecognized compensation cost related to stock options granted. The cost is expected to be recognized over the next 1.78 years. Total stock option expense recorded in 2012 and 2011 was approximately $142,000 and $83,000, respectively. There were no options exercised during 2012 and 2011.

A summary of the status of the Company's non-vested shares of restricted stock for 2012 and 2011 and changes during 2012 and 2011 are presented below:

	Shares	Weighted Average Grant-Date Fair Value
Non-vested at December 31, 2010	196,024	$ 1.10
Granted	-	-
Vested	(158,524)	$ 1.20
Cancelled	-	-
Non-Vested at December 31, 2011	37,500	$ 0.67
Granted	-	-
Vested	(37,500)	$ 0.67
Cancelled	-	-
Non-Vested at December 31, 2012	-	$ -

As of December 31, 2012, there was no unrecognized compensation cost related to restricted stock awards. As of December 31, 2012, 2,104,202 shares were vested. As of December 31, 2011, 2,066,702 shares were vested. The total fair value of shares vested during 2012 and 2011 was approximately $25,000 and $190,000. Total compensation from continuing operations recorded in 2012 and 2011 was approximately $1,000 and $116,000, respectively.

(12) EMPLOYEE STOCK PURCHASE PLAN

In May 2000, the Company adopted the 2000 Employee Stock Purchase Plan (the Stock Purchase Plan), which permits the eligible employees of the Company and its subsidiaries to purchase shares of the Company's common stock, at a discount, through regular monthly payroll deductions of up to 10% of their pre-tax gross salary. Subject to adjustment for stock splits, stock dividends and similar events, a maximum of 300,000 shares of common stock may be issued under the Stock Purchase Plan. During the years ended December 31, 2012 and 2011, there were no shares issued under the Stock Purchase Plan.

(13) EMPLOYEE DEFINED CONTRIBUTION PLANS

On January 17, 1994, the Company established the StockerYale, Inc. 401(k) Plan (the Plan). Under the Plan, employees are allowed to make pre-tax retirement contributions. In addition, the Company may make matching contributions, not to exceed 100% of the employee contributions, and profit sharing contributions at its discretion. The Company made matching contributions of $31,000 in the year ended December 31, 2012 and $27,000 in the year ended December 31, 2011. The Company incurred costs of approximately $1,700 in 2012 and approximately $2,300 in 2011 to administer the Plan.

The Company also has voluntary contribution pension schemes in Ireland and in the United Kingdom. In the United Kingdom, the Company contributes a maximum of 3% of the participating employee salaries, with one exception, where the maximum contribution is 10%. The plan is voluntary, with plan administration costs coming out of the plan itself. The Company made contributions of approximately $41,000 and $38,000 in the years ended December 31, 2012 and 2011, respectively. In Ireland, the Company also has a voluntary plan that matches contributions for those participating employees with minimum of 6 months of service. After two years of service, the Company will match up to a maximum of 5% of salary. The Company made contributions of approximately $22,000 and $28,000 in the years ended December 31, 2012 and 2011, respectively. Plan administration costs come out of the plan itself.

(14) DISCONTINUED OPERATIONS

StockerYale Canada was sold to Coherent on October 13, 2009, and has been reported as discontinued operations. Amounts recorded in loss from discontinued operations for the years ended December 31, 2012 and 2011 represent the professional fees and other expenses associated with the sold business. The loss from discontinued operations for the years ended December 31, 2012 and 2011 was $0 and $19,000, respectively.

(15) COMMITMENTS AND CONTINGENCIES

Other obligations and contingent liabilities

The Company leases approximately 3,600 square feet for its corporate headquarters and sales office in Salem, New Hampshire. The term of the lease requires monthly tenant at-will payments with a 90 day termination notice. Base rent is $2,550 per month plus the tenant’s share of expenses.

ProPhotonix (IRL) Limited leases approximately 10,000 square feet for its operations in Cork, Ireland. The lease term began on August 22, 2008 for a term of five years with rent and service charges of €102,000 per year.

ProPhotonix Limited, a U.K. subsidiary, leases approximately 13,000 square feet of space in Hatfield Broad Oak, Hertfordshire, U.K. The lease has a term of nine years ending September 29, 2013. Rent charges are £87,000 per year.

The Company utilizes, or has assumed, capital leases to finance purchases of equipment or vehicles. There was approximately $22,000 and $0 payable in principal and interest under these leases at December 31, 2012 and December 31, 2011, respectively. The Company records depreciation expense on assets acquired under a capital lease in the consolidated statement of operations.

The net book value of assets acquired under capital leases at December 31, 2012 and December 31, 2011, is as follows:

	2012	2011
Assets under capital lease	$ 621,000	$ 571,000
Less—accumulated depreciation	(574,000)	(497,000)
Assets under capital lease, net	$ 47,000	$ 74,000

Scheduled future maturities of debt, and operating lease obligations for the next five years:

Due by period	**2013**	**2014**	**2015**	**2016 +**	**Total**
			in thousands		
Debt obligations	$ 1,744	$ 909	$ 396	$ —	$3,049
Operating lease obligations	165	—	—	—	165
	$ 1,909	$ 909	$ 396	$ —	$3,214

The Company expensed approximately $293,000 and $313,000 in rent for the years ended December 31, 2012 and 2011, respectively.

(16) LEGAL PROCEEDINGS

The Company is party to various legal proceedings generally incidental to its business. Although the disposition of any legal proceedings cannot be determined with certainty, it is the Company's opinion that any pending or threatened litigation will not have a material adverse effect on the Company's results of operations, cash flow or financial condition.

(17) SUBSEQUENT EVENTS

On June 20, 2013, the Company entered into a Term Loan agreement with a Lender related to the Company CEO, Tim Losik. The Term Loan provides availability to the Company of up to $2.0 million during the term of the Loan, as follows, subject to certain restrictions:

(a) Available Loan: $2.0 million; minimum draw $250,000
(b) Interest Rate: 12.25% per annum
(c) Interest payments only: June 30, 2013 through May 31, 2014
(d) Principal Repayment term: 36 months (June 30, 2014 through May 31, 2017)

On June 20, 2013, the Company entered into a Term Loan agreement with the PPI Bond holder to provide up to $1.0 million of loan availability subject to certain terms as follows:

(a) Available Loan (subject to (b) below): $1.0 million; minimum draw $125,000
(b) 50% of each advance shall be used to repay amounts owed under the PPI Bond (Note 8)
(c) Interest Rate: 12.25% per annum
(d) Interest payments only: June 30, 2013 through May 31, 2014
(e) Principal Repayment term: 36 months (June 30, 2014 through May 31, 2017)

The Company has evaluated subsequent events through June 20, 2013, the date which the financial statements were available to be issued, and there were no additional events that impacted these financial statements or required additional disclosure to the financial statements.

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