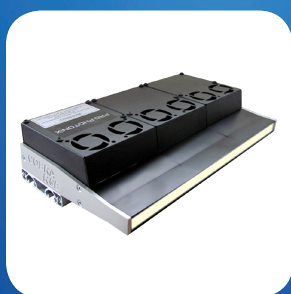
PRO PHOTONIX

# Annual Report 2016




About the pictures on the front cover (left to right):

**Warehouse Robotics Laser Module**

This custom infra-red laser module was designed in-house and manufactured for a global distribution and logistics company. The module projects a perfectly straight horizontal laser line with uniform thickness, for the most reliable obstacle detection. Leveraging our laser diode and optics supply chain, the Company supplied this customer with the optimum solution including custom modulation electronics for integration with the robot's camera system.

**COBRA Cure FX3 UV LED Curing System**

The COBRA Cure FX3 is an innovative UV LED Curing system, delivering up to $16W/cm^2$ or $42J/cm^2$. It has been designed specifically for UV curing of inks, coatings and adhesives. Its innovative design incorporates the many benefits of a LED curing systems as well as unique end-user focused features to guarantee a consistent, reliable cure over the lifetime of the system.

**Laser Module for Factory Alignment System**

The Company supplies a green (520nm) laser module matching the specification of legacy 532nm lasers to ensure backwards compatibility in the field. ProPhotonix improved the performance and greatly increase the reliability of the customer's system by using a direct diode laser rather than the competitor's diode pumped solid state laser. ProPhotonix' production line flexibility ensures the customer can be supplied with several variants of the laser with different beam profiles.

**COBRA RGB LED Line Light**

COBRA RGB LED line light delivers extremely bright, uniform, multispectral illumination in line scan applications that can be configured with up to 3 different wavelengths. An example target application is the print inspection market. High brightness, multi-wavelength lights allows faster processing of print product without the loss of inspection integrity.

**Laser Module for Ground-penetrating Radar**

A long-standing customer required a compact alignment laser module to fit into their handheld devices. Quality, reliability and robustness are critical. ProPhotonix developed a compact, custom module with red and green laser diode variants providing the customer with options for use under a wide range of light conditions in the field.

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***Corporate***
ProPhotonix Limited
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**Business Activities**:

ProPhotonix consists of two business units: an LED systems manufacturing business based in Ireland (Cork), and a laser modules production and laser diode distribution business located in the United Kingdom (Hatfield Broad Oak). Corporate headquarters and the North American sales activities are based in Salem, New Hampshire, USA. The fundamental strategy of the Company is growth in revenue through its existing customers, new customer activity, and new product and market expansion.

ProPhotonix Limited sells its products principally into three markets: industrial, (primarily machine vision illumination), medical, and homeland security and defense. The Company foresees growth opportunities in all three markets it serves which are briefly described below:

*Industrial (Machine Vision)*

Within the industrial market, machine vision is the term used to describe computerized analysis for controlling manufacturing processes, for example automated inspection. In terms of quality and speed, lighting is often a critical component in machine vision and the Company manufactures both LED systems and lasers designed specifically for this market.

*Medical*

The medical and dental market requires many different LED systems and laser modules for unique processses, procedures, and applications. The Company provides a variety of products for medical and dental applications to current customers including, a world leader in stationary imaging equipment, a portable x-ray equipment and dental imaging manufacturer, and a surgical illumination device manufacturer. The Company intends to broaden its product marketing effort in the medical field since it offers significant long-term revenue growth opportunities.

*Homeland Security & Defense*

LED systems, laser modules and laser diodes are used in a wide variety of applications in the security and defense fields. The Company currently supplies several defense sighting manufacturers in the US and Europe, as well as leading manufacturers of Auto Number Plate Recognition systems. This market offers significant growth opportunities for ProPhotonix over the next several years and the Company is currently marketing its laser and LED capabilities to additional security and Optical Character Recognition systems companies in this market space.

2016 Annual Report to Shareholders

To the Shareholders of ProPhotonix Limited:

We entered 2016 with positive financial momentum and continued making good financial progress; most notably, achieving a second year of net income. In addition, the ProPhotonix team has been diligently pursuing new customers, as well as new product and market initiatives which help set the stage for the future. However, as with the headwinds in early 2016, there are many complexities and uncertainties which may adversely affect ProPhotonix: economic slowdown, Brexit uncertainty and an ever changing world-wide political landscape. Our management does not dwell on these uncontrollable matters, but remains acutely aware of the potential impact and necessity for swift response and change if needed.

| | |
|---|---|
| Revenue Growth | 13% |
| Operating Income growth | 89% |
| Net Income growth | 348% |
| EU funded Grant | €360,000 |
| New UV LED products released | |
| New Multi wavelength LED products released | |

Financial Progress:

Revenue increased by 13% in 2016, mainly due to a 44% increase in laser module sales; while our gross margin rate improved from 41.4% to 45.4%, resulting from this volume increase as well as a better product mix. Net income increased 348%, due to the increase in operating income, reduced financing costs and the benefit of a reversal of a contingent tax liability. The balance sheet also continued to improve in 2016. Term debt declined $1,100,000, ending the year with a balance of $400,000, the lowest level in decades. During 2016, order bookings increased 6% to $16.7 million from 2015, with the book-to-bill ratio continuing to be greater than one at 1.03 (2015: 1.09). Our backlog at December 31, 2016 remained flat from 2015 at $5.6 million.

| ($000's) | 2016 | 2015 |
|---|---|---|
| Sales | $ 16,245 | $ 14,411 |
| Gross Profit | 7,383 | 5,970 |
| GP% | 45.4% | 41.4% |
| Income from Operations | 1,492 | 790 |
| Net Income | $ 1,255 | $ 280 |

Customer and Product Development Initiatives:

During the year, the ProPhotonix engineering team completed the development of several products and implemented a number of new technology capabilities. Continuing with the strategy we announced last year relating to the Ultraviolet (UV) LED market, the Company released the new COBRA Cure™ FX2 and FX3 products. These products are ideally suited to a range of UV curing applications including printing, adhesives and coatings. Our UV LED product development plan includes variants of the FX lamp and additional UV light sources with higher power, configurable interfaces and advanced sensing capabilities. The significant investments in UV product development occurred throughout the year and will continue throughout 2017. These investments will have a short term depressing effect on earnings in 2017 though are expected will set the stage for sustainable and profitable growth well beyond 2017.

We introduced our new COBRA™ RGB LED line light, a multi wavelength device which has applications in optical sorting, inspection and printing applications. On January 19, 2017, we also announced our new MultiSpec product that allows for discrete control of up to 12 different wavelengths allowing users to maximize contrast by selecting the optimum color mix and varying the intensity of each wavelength to their specific application need, uniquely suited to hyper-spectral imaging application.

In addition, the Company also signed a services agreement with a Fortune 50 company to develop a lighting solution for their medical product application. The initial project value was $40,000 and since, additional projects were added which has grown to a value total of $532,000 for engineering services. Future development projects are anticipated from this customer along with production of various products currently being developed. Lastly, the Company entered into an EU funded Fast Track to Innovation program to partner with other participants, including the end customer, in the development of a high power digital laser for a railway industry inspection system. The grant estimate is up to €360,000 with completion of the entire development project on June 1, 2018.

As 2016 concluded, we made a significant investment on our European sales team to increase our European sales coverage and customer support. As with all investments, returns come with time and with our expanded customer coverage we expect future revenue growth from the European region; with expected further expansion in 2017.

<u>Strategy:</u>

In last year's Statement to the Shareholders in the annual report, the Company's longer term strategy continues to be one of strategic repositioning to include a market(s) directed product portfolio complementing our robust OEM centered business. ProPhotonix has and will continue to make such investments in fulfillment of our strategy.

As noted last year, we have identified two promising opportunities and we are concentrating our engineering talents in defined market areas that we believe are poised for fast market expansion. The first of these is the UV LED and laser market for various applications including: printing, curing, bonding, 3D printing, bio-luminescence, medical microscopy and other applications. As noted above, the Company continued its progress in this area with the follow-on COBRA Cure™ product releases. We plan to continue to launch new higher power products while continuously evolving our current product lines to serve this market in 2017 and beyond.

Our remaining focus is on the continuing market requirement for multi-wavelength devices and systems, both laser and LED solutions. Increasingly, customers are seeking multi-wavelength solutions requiring innovative optics, complex electronics, on-board sensing capabilities and sophisticated software control. We see opportunities which include a broad range of applications in printing, microscopy, industrial inspection and sorting, embedded camera and sensor calibration, solar simulation and security markets. As noted, the Company has introduced two new products addressing this market (RGB and Multispec). We intend to enhance and expand this offering as market demand dictates.

I am pleased with our improved financial performance and business accomplishments, and believe we will continue improvement in 2017 and beyond. We are positioned for success more readily than any other time in the recent history of the Company with the resources, talent and opportunities we cultivated during 2016.

In conclusion, I thank you, my co-workers, our customers, suppliers, service providers and investors for your continued support!

Respectfully submitted,

Tim Losik
President and Chief Executive Officer

## Director Remuneration Report

*For the year ended December 31, 2016*

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

| Executive Director | Salary ($) | Bonus ($) | Pension ($) | Other (1) ($) | Total Cash Compensation ($) | Options ($) | Total ($) | Total All Compensation 2016 ($) | Total All Compensation 2015 ($) |
|---|---|---|---|---|---|---|---|---|---|
| Tim Losik | 300,750 | 150,000 | 6,000 | - | 456,750 | 51,864 | 51,864 | 508,614 | 359,041 |
| **Total Executive Compensation** | **300,750** | **150,000** | **6,000** | **-** | **456,750** | **51,864** | **51,864** | **508,614** | 359,041 |
| **Non-Executive Director** | | | | | | | | | |
| Ray Oglethorpe | - | - | - | 25,000 | 25,000 | 6,485 | 6,485 | 31,485 | 27,968 |
| Timothy Steel | - | - | - | 25,000 | 25,000 | 6,485 | 6,485 | 31,485 | 27,968 |
| Vincent Thompson | - | - | - | 25,000 | 25,000 | 6,485 | 6,485 | 31,485 | 27,968 |
| Mark Weidman | - | - | - | 25,000 | 25,000 | 6,485 | 6,485 | 31,485 | 27,968 |
| **Total Non-Executive Compensation** | **-** | **-** | **-** | **100,000** | **100,000** | **25,940** | **25,940** | **125,940** | 111,872 |

**Director Share Options:**

| Director | Options @ 12/31/15 | Options Granted | Options Forfeited | Options @ 12/31/16 |
|---|---|---|---|---|
| **Tim Losik** | 4,900,000 | - | - | 4,900,000 |
| **Ray Oglethorpe** | 1,959,006 | 150,000 | - | 2,109,006 |
| **Timothy Steel** | 1,445,433 | 150,000 | - | 1,595,433 |
| **Vincent Thompson** | 1,445,433 | 150,000 | - | 1,595,433 |
| **Mark Weidman** | 1,000,000 | 150,000 | - | 1,150,000 |
| **Total All Directors** | 10,749,872 | **600,000** | **-** | **11,349,872** |

(1) Other compensation for non-executive directors represents cash payments expensed in the current year.

# ProPhotonix Limited

# Consolidated Financial Statements

*Years Ended December 31, 2016 and 2015*

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## FINANCIAL STATEMENTS

## INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

## Independent Auditors' Report

The Board of Directors
ProPhotonix Limited

### Report on the Financial Statements

We have audited the accompanying consolidated financial statements of ProPhotonix Limited and its subsidiaries, which comprise the consolidated balance sheets as of December 31, 2016 and 2015, and the related consolidated statements of income and comprehensive income, stockholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

This report is made solely to the company's stockholders, as a body, in accordance with the terms of our engagement. Our audit work has been undertaken so that we might state to the company's stockholders those matters we have been engaged to state to them in this report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's stockholders, as a body, for our audit work, for this report, or for the opinions we have formed.

### *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 audits. We conducted our audits 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, 2016 and 2015, and the results of their operations and their cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.

kpmg LLP

KPMG LLP

Cambridge
United Kingdom
March 15, 2017

**FINANCIAL STATEMENTS**

**PROPHOTONIX LIMITED**

**CONSOLIDATED BALANCE SHEETS**

($ in thousands except share and per share data)

| **December 31** | | **2016** | | **2015** |
|---|---|---|---|---|
| **Assets** | | | | |
| Current assets: | | | | |
| Cash and cash equivalents | $ | 911 | $ | 434 |
| Accounts receivable, less allowances of $30 in 2016 and $21 in 2015 | | 2,302 | | 2,751 |
| Inventories | | 2,155 | | 1,550 |
| Prepaid expenses and other current assets | | 298 | | 140 |
| Total current assets | | 5,666 | | 4,875 |
| Net property, plant and equipment | | 342 | | 132 |
| Goodwill | | 372 | | 385 |
| Other long-term assets | | 74 | | 81 |
| **Total assets** | **$** | **6,454** | $ | 5,473 |
| **Liabilities and Stockholders' Equity** | | | | |
| Current liabilities: | | | | |
| Revolving credit facility | $ | 1,049 | $ | 1,334 |
| Current portion of long-term debt | | 402 | | 966 |
| Accounts payable | | 1,454 | | 1,260 |
| Accrued payroll, benefits and incentive compensation | | 641 | | 380 |
| Customer advances | | 416 | | 52 |
| Deferred revenue | | 213 | | 65 |
| Accrued warranty expenses | | 149 | | 134 |
| All other accrued expenses | | 404 | | 404 |
| Capital lease obligations | | 68 | | - |
| Total current liabilities | | 4,796 | | 4,595 |
| Long-term debt, net of current portion | | - | | 508 |
| Long term capital lease obligations, net of current portion | | 52 | | - |
| Other long-term liabilities | | - | | 178 |
| **Total liabilities** | | **4,848** | | 5,281 |
| **Stockholders' Equity:** | | | | |
| Common stock, par value $0.001; shares authorized 250,000,000 at December 31, 2016 and at December 31, 2015; 83,665,402 shares issued and outstanding at December 31, 2016 and at December 31, 2015 | | 84 | | 84 |
| Additional paid-in capital | | 112,038 | | 111,860 |
| Accumulated deficit | | (111,479) | | (112,734) |
| Accumulated other comprehensive income | | 963 | | 982 |
| **Total stockholders' equity** | | **1,606** | | 192 |
| **Total liabilities and stockholders' equity** | **$** | **6,454** | $ | 5,473 |

See the notes to consolidated financial statements.

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

| | Years Ended December 31, | |
|---|---|---|
| | **2016** | **2015** |
| Revenue | $ 16,245 | $ 14,411 |
| Cost of Revenue | (8,862) | (8,441) |
| Gross Profit | 7,383 | 5,970 |
| Research & Development Expenses | (814) | (654) |
| Selling, General & Administrative Expenses | (5,077) | (4,526) |
| Operating Income | 1,492 | 790 |
| Other Income, net (including release of historic tax contingency see Note 9) | 344 | 131 |
| Foreign Currency Exchange Losses | (360) | (259) |
| Warrant & Debt Acquisition Expense | (88) | (158) |
| Interest Expense | (133) | (224) |
| Income Before Taxes | 1,255 | 280 |
| Income Taxes | - | - |
| Net Income | $ 1,255 | $ 280 |
| Other Comprehensive Income: | | |
| Foreign currency translation | (19) | 170 |
| Total Comprehensive Income | $ 1,236 | $ 450 |

| | | |
|---|---|---|
| Net Income Per Share: | | |
| Basic and diluted: | | |
| Basic net income per share | $0.015 | $0.003 |
| Diluted net income per share | $0.014 | $0.003 |
| Shares used in per share calculations - Basic | 83,665,402 | 83,665,402 |
| Shares used in per share calculations - Diluted | 90,740,402 | 83,665,402 |

See the notes to consolidated financial statements.

**PROPHOTONIX LIMITED**

**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)**

(in thousands)

| | Common Stock | | | | | |
|---|---|---|---|---|---|---|
| | **Shares** | **Par $0.001** | **Additional Paid in Capital** | **Accumulated Deficit** | **Accumulated Other Comprehensive Income** | **Total Stockholders' Equity (Deficit)** |
| **Balance December 31, 2014** | 83,665 | $ 84 | $111,583 | $ (113,014) | $ 812 | $ (535) |
| Share based compensation, net of forfeitures ................ | - | - | 277 | - | - | 277 |
| Translation adjustment ..... | - | - | - | - | 170 | 170 |
| Net Income ...................... | - | - | - | 280 | - | 280 |
| **Balance December 31, 2015** | 83,665 | $ 84 | $111,860 | $ (112,734) | $ 982 | $ 192 |
| Share based compensation, net of forfeitures ................ | - | - | 178 | - | - | 178 |
| Translation adjustment ..... | - | - | - | - | (19) | (19) |
| Net Income ...................... | - | - | - | 1,255 | - | 1,255 |
| **Balance December 31, 2016** | **83,665** | **$ 84** | **$112,038** | **$ (111,479)** | **$ 963** | **$ 1,606** |

See the notes to consolidated financial statements.

**PROPHOTONIX LIMITED**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)

| **Years Ended December 31** | **2016** | **2015** |
|---|---|---|
| **Cash flows from operating activities** | | |
| Net income | **$ 1,255** | **$ 280** |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Stock-based compensation expense | 178 | 277 |
| Depreciation and amortization | 75 | 101 |
| Foreign exchange (gain) | 74 | (51) |
| Amortization of debt discount and financing costs | 60 | 130 |
| Provision for inventories | 120 | 95 |
| Provision for bad debts | 9 | 4 |
| Other changes in assets and liabilities: | | |
| Accounts receivable | 360 | (362) |
| Inventories | (809) | (127) |
| Prepaid expenses and other current assets | (168) | 22 |
| Accounts payable | 246 | (58) |
| Accrued expenses | 836 | 136 |
| Other assets and liabilities | 6 | (47) |
| **Net cash provided by operating activities** | **2,242** | 400 |
| **Investing** | | |
| Purchase of property, plant and equipment | (121) | (77) |
| **Net cash used in investing activities** | **(121)** | **(77)** |
| **Financing** | | |
| Borrowings of revolving credit facilities, net | (237) | 312 |
| Capital lease | (66) | - |
| Principal repayment of long-term debt | (1,100) | (750) |
| **Net cash used in financing activities** | **(1,403)** | (438) |
| Effect of exchange rate on cash | (241) | 218 |
| Net change in cash and equivalents | 477 | 103 |
| Cash and equivalents at beginning of period | 434 | 331 |
| **Cash and equivalents at end of period** | **$ 911** | $ 434 |
| **Supplemental cash flow information:** | | |
| Cash paid for interest | **$ 133** | **$ 224** |

See the notes to consolidated financial statements.

# 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 manufacturer of laser modules and a distributor of laser diodes 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 is currently incorporated in the state of Delaware. The common stock of the Company now trades on the OTC Market in the U.S. under the trading symbol “STKR” and is also traded on the London Stock Exchange, plc (AIM listing), under the trading symbol “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, 2016 and 2015, the Company recorded net income of approximately $1,255,000 and $280,000, respectively. Net cash inflow from operating activities for the same time periods were approximately $2,242,000 and $400,000, 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. The Company believes that it has adequate available working capital to continue to trade for at least the next twelve months from the issuance of these financial statements.

## (2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying consolidated financial statements are prepared in conformity with U.S. 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 (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. 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

Accounts receivable are recorded at the invoiced amount and do not bear interest. Amounts collected on trade receivables are included in net cash provided by operating activities in the consolidated statements of cash flows. 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. Allowance for doubtful accounts are established for accounts that are potentially uncollectible. The Company also has accounts receivables insurance at ProPhotonix Limited, a U.K. subsidiary, which also covers most of the larger customers at the ProPhotonix (IRL) Limited subsidiary, and allows the Company to submit a claim on overdue receivables in excess of 60 days past invoice due date. The Company has not made any claims in either 2016 or 2015. Determining adequate allowances for accounts receivable requires management's judgment in combination with Company policies and procedures. Management's assessment includes customer payment trends, as well as discussions with customers over past due amounts. 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** | **2016** | **2015** |
|---|---|---|
| | **In thousands** | |
| Balance at beginning of period | $ 21 | $ 20 |
| Charges to costs and expenses | 10 | 6 |
| Account write-offs and other deductions | (1) | (5) |
| Balance at end of period | $ 30 | $ 21 |

## 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 market. 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 when indicators of impairment are present, 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 the asset is determined not to be recoverable, 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.

## INCOME PER SHARE

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

As of December 31, 2016, 22,965,040 shares underlying options and 4,456,067 shares underlying warrants could potentially have been included in the calculation of diluted shares. However, as the exercise price at December 31, 2016 was $0.062 per share, only 5,175,000 exercisable options and 1,900,000 warrants were included in the calculation of earnings per share. All other options and warrants exercise price exceeded the market price.

As of December 31, 2015, 22,965,040 shares underlying options and 8,026,067 shares underlying warrants would have been included in the calculation of diluted shares. However, as the exercise price exceeded the market price on December 31, 2015, none of these have been included in the calculation of earnings per share.

## 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 free on board 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 upon completion of performance, subject to any project management assessments as to the status of work performed.

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, 2016 | 2015 |
|---|---|---|
| | In thousands | |
| Balance at beginning of period | $ 134 | $ 146 |
| Charges to costs and expenses | 121 | 109 |
| Account write-offs and other deductions | (106) | (121) |
| Balance at end of period | $ 149 | $ 134 |

## ADVERTISING EXPENSE

The Company expenses advertising costs as incurred. Advertising expenses for the years ended 2016 and 2015 were approximately $87,000 and $81,000, respectively.

## PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment are stated at cost. The Company provides for depreciation on a straight-line basis over the assets estimated useful lives. Plant and equipment held under capital lease are amortized on a straight-line basis over the shorter of the lease term or estimated useful life of the asset. Capital leases are stated at the present value of minimum lease payments. 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 asset and 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 measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. 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, 2016 or 2015.

## 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. Generally the grants vest over terms of one 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 2016, the Company recognized approximately $178,000 of stock-based compensation related to options, all of which was charged to general and administrative expense. During 2015, the Company recognized approximately $277,000 of stock-based compensation related to options, all of which was charged to 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.

## 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 (deficit) (accumulated other comprehensive income) in the accompanying consolidated balance sheets.

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

**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.

At December 31, 2016, the Company estimated the fair value of long term fixed rate debt to be approximately $507,000 compared to its carrying value of $475,000 (2015: fair value of approximately $1,849,000 compared to its carrying value of $1,783,000).

**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 one customer accounting for 10% or more of consolidated revenues in 2016 and no customer accounting for 10% or more of consolidated revenues in 2015. The Company had no customer that accounted for 10% or more of the outstanding accounts receivable balance at December 31, 2016 or at December 31, 2015. The Company maintains its cash and cash equivalents in bank deposit accounts, which at times may exceed insured limits. At December 31, 2016, the amount in excess of governmental insurance protection was approximately $0.7 million, measured across all entities and jurisdictions. At December 31, 2015, the amount in excess of governmental insurance protection was approximately $0.3 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

*Revenue Recognition.* In May 2014, the Financial Accounting Standards Board (FASB) issued new revenue recognition guidance to provide a single, comprehensive revenue recognition model for all contracts with customers. Under the new guidance, an entity will recognize revenue to depict the transfer of promised goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services. A five step model has been introduced for an entity to apply when recognizing revenue. The new guidance also includes enhanced disclosure requirements, and is effective January 1, 2018, with early adoption permitted for January 1, 2017. Entities have the option to apply the new guidance under a retrospective approach to each prior reporting period presented, or a modified retrospective approach with the cumulative effect of initially applying the new guidance recognized at the date of initial application within the Consolidated Statement of Changes in Stockholders' Equity. We plan to adopt the new guidance effective January 1, 2018. At this time we have not identified any impacts to our financial statements that we believe will be material in the year of adoption. Based on the current estimated impact to our financial statements, we plan to adopt the new guidance under the modified retrospective approach.

*Measurement of Inventory.* In July 2015, the FASB issued final guidance that simplifies the subsequent measurement of inventories by replacing today's lower of cost or market test with a lower of cost and net realizable value test. This guidance applies only to inventories for which cost is determined by methods other than last-in first out (LIFO) and the retail inventory method (RIM). Entities that use LIFO or RIM will continue to use existing impairment model. The guidance is effective for public entities for fiscal years beginning after 15 December 2015, and interim periods within those fiscal years. This guidance had no impact to our financial statements.

*Business combinations – Measurement period adjustments.* In September 2015, the FASB issued new guidance that eliminates the requirement that an acquirer in a business combination account for measurement-period adjustments retrospectively. Instead, an acquirer will recognize a measurement-period adjustment during the period in which it determines the amount of the adjustment. The guidance is effective for public entities for fiscal years beginning after 15 December 2015, and interim periods within those fiscal years. This guidance had no impact to our financial statements.

*Financial Instruments - Classification and Measurement.* In January 2016, the FASB issued changes to the accounting for financial instruments that primarily affect equity investments, financial liabilities under the fair value option, and the presentation and disclosure requirements. This standard is effective for us beginning in the first quarter of 2018; certain provisions allow for early adoption and we are evaluating whether we will do so. The new standard should be applied by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption, with certain exceptions. We have not yet determined the impact of the new standard on our consolidated condensed financial statements.

*Leases.* In February 2016, the FASB issued a new lease accounting standard requiring that we recognize lease assets and liabilities on the balance sheet. This standard is effective for us beginning in the first quarter of 2019; early adoption is permitted and we are evaluating whether we will do so. The new standard must be adopted using a modified retrospective transition which includes certain practical expedients. We have not yet determined the impact of the new standard on our consolidated condensed financial statements.

*Share-Based Compensation.* In March 2016, the FASB issued an accounting standard update aimed at simplifying the accounting for share-based payment transactions. Included in the update are modifications to the accounting for income taxes upon vesting or settlement of awards, employer tax withholding on share-based compensation, forfeitures, and financial statement presentation of excess tax benefits. This standard is effective for us beginning in the first quarter of 2017 and we will adopt it at that time. We do not believe this will have a significant impact on our consolidated financial statements, as any employer tax will be relatively insignificant for U.S. based employees and U.K. employees are covered under the EMI reporting scheme.

*Income Taxes - Intra-Entity Asset Transfers.* In October 2016, the FASB issued an accounting standard update aimed at recognizing the income tax consequences of intra-entity transfers of assets other than inventory when they occur. This removes the exception to postpone recognition until the asset has been sold to an outside party. This standard is effective for us beginning in the first quarter of 2018, and early adoption is permitted. It is required to be applied on a modified retrospective basis through a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. We have not yet determined the impact of the new standard on our consolidated condensed financial statements.

*Goodwill Impairment.* In January 2017, the FASB issued new guidance that eliminates the requirement to calculate the implied fair value of goodwill (i.e., Step 2 of today's goodwill impairment test) to measure a goodwill impairment charge. Instead, entities will record an impairment charge based on the excess of a reporting unit's carrying value over its fair value (i.e. measure the charge based on today's Step 1). The standard has tiered effective dates, starting in 2020 for calendar-year public business entities that meet the definition of an SEC filer. Early adoption is permitted for annual and interim goodwill impairment testing after 1 January, 2017. We have not yet determined the impact of the new standard on our consolidated condensed 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** | **2016** | **2015** |
|---|---|---|
| | **In thousands** | |
| Finished goods | $ 508 | $ 369 |
| Work in-process | 397 | 252 |
| Raw materials | 1,832 | 1,433 |
| Gross inventories | $ 2,737 | $ 2,055 |
| Inventory reserves | (582) | (505) |
| Net inventories | $ 2,155 | $ 1,550 |

Management performs quarterly reviews of inventory and either reserves or disposes of items not required by their manufacturing plan, as well as 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** | **2016** | **2015** |
|---|---|---|
| | **In thousands** | |
| Buildings and building improvements | $ 258 | $ 253 |
| Computer equipment | 394 | 407 |
| Machinery and equipment | 1,681 | 1,511 |
| Furniture and fixtures | 419 | 399 |
| Property, plant and equipment | $ 2,752 | $ 2,570 |
| Less accumulated depreciation | (2,410) | (2,438) |
| Net property, plant and equipment | $ 342 | $ 132 |

Depreciation expense from operations was approximately $75,000 and $101,000 in the years ended December 31, 2016 and 2015, respectively.

## (6) GOODWILL

The Company uses a three-step approach to a goodwill impairment test. First, ASU 2011-08 allows entities 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 unit's 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 units and implied fair value of goodwill, the impairment analysis is highly sensitive to actual versus forecast results. Finally, if the estimated value is less than the carrying value, an impairment loss is recognized for any excess of the carrying amount of the reporting unit's goodwill over the implied fair value of that goodwill.

In connection with the annual impairment test of goodwill, performed at the end of the fourth quarter 2016, and at the end of the fourth quarter 2015, the Company concluded that no impairment existed.

The changes in the carrying amount of goodwill for the years ended December 31, 2016 and 2015 were as follows:

| | December 31, 2016 | December 31, 2015 |
|---|---|---|
| | ( In thousands) | |
| Beginning of the year | $ 385 | $ 429 |
| Effect of exchange rate | (13) | (44) |
| End of year | $ 372 | $ 385 |

The Company operates in two reporting units: LED's (light emitting diode systems) and Laser & Diodes. Goodwill as of December 31, 2016 and 2015 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 2016. 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, 2016 for each intangible asset class.

| | Gross Carrying Amount | Accumulated Amortization | Net Balances |
|---|---|---|---|
| | | (in thousands) | |
| Acquired customer contracts and relationships | 1,543 | (1,543) | - |
| Acquired technology design and programs | 261 | (261) | - |
| Other | 85 | (85) | - |
| Total | $ 1,889 | $ (1,889) | $ - |

Gross carrying amounts and accumulated amortization of intangible assets were as follows as of December 31, 2015 for each intangible asset class.

| | Gross Carrying Amount | Accumulated Amortization | Net Balances |
|---|---|---|---|
| | | (in thousands) | |
| Acquired customer contracts and relationships | 1,850 | (1,850) | - |
| Acquired technology design and programs | 313 | (313) | - |
| Other | 102 | (102) | - |
| Total | $ 2,265 | $ (2,265) | $ - |

## (8) DEBT

| Years Ended December 31 | | 2016[1] | 2015 |
|---|---|---|---|
| | | In thousands | |
| Senior Fixed Rate Secured Bond ("PPI Bond") to a private investor, maturing on June 30, 2017 with an interest rate of 8%, at December 31, 2016 and at December 31, 2015. | Principal Amount | $182 | $902 |
| | Less: Unamortized discount and debt issuance costs | $ (3) | $ (33) |
| | Long-term debt less unamortized discount and debt issuance costs | $179 | $869 |
| Senior Fixed Rate Secured Bond to a private investor, maturing on June 30, 2017, with an interest rate of 12.25%, at December 31, 2016 and at December 31, 2015. | Principal Amount | $75 | $213 |
| | Less: Unamortized discount and debt issuance costs | $ (1) | $ (10) |
| | Long-term debt less unamortized discount and debt issuance costs | $74 | $203 |
| Senior Fixed Rate Secured Bond to a private investor, maturing on June 30, 2017, with an interest rate of 12.25%, at December 31, 2016 and at December 31, 2015 | Principal Amount | $151 | $426 |
| | Less: Unamortized discount and debt issuance costs | $ (2) | $ (24) |
| | Long-term debt less unamortized discount and debt issuance costs | $149 | $402 |
| Borrowings under Revolving Credit facility with Barclays Bank Sales Financing with an interest rate of 2.50% above Barclay's base rate at December 31, 2016 and at December 31, 2015 (3.0% as of December 31, 2016 and at December 31, 2015). | Principal Amount | $1,049 | $1,334 |
| Total All Debt | Principal Amount | $1,457 | $2.875 |
| | Less: Unamortized discount and debt issuance costs | $ (6) | $ (67) |
| | Long-term debt less unamortized discount and debt issuance costs | $1,451 | $2,808 |

As of December 31, 2016, the Company had approximately $ 1,919,000 available under the various borrowing facilities.

Scheduled future maturities of debt for the next five years:

| Due by period | 2017 | 2018 | 2019 | 2020 | 2021 | Total |
|---|---|---|---|---|---|---|
| | | | | in thousands | | |
| Debt obligations.................... | $ 402 | $ - | $ - | $ - | $ - | $ 402 |

## BORROWING AGREEMENTS

### 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 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 amend the terms 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 below as part of the Term Loan provided to the Company

(b) Issue 1,900,000 warrants over common stock of the Company exercisable at a price of $0.03 per share through June 20, 2023 as described in Note 10. The fair value of these warrants of $55,185 was deducted from the carrying value of the bond and is being amortized over the remaining term of the PPI Bond

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

(d) Interest Rate: 8% per annum

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

(f) Principal Repayment: €15,000 per month plus interest July 1, 2014 through June 30, 2015, thereafter principal and interest monthly €56,378 ($61,486) from July 1, 2015 through June 30, 2017*

(g) One-time fee of €31,413 ($34,259) payable on June 30, 2017. This fee is being accrued ratably over the life of the loan, payable in June, 2017. In addition, the Company recorded debt acquisition costs of $134,484 which is being amortized over the life of the amended term note.

* In addition to the terms above, the bondholder will be entitled to accelerated principal payments, on a quarterly basis, 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). Such payments are due within 45 days of the end of such calendar quarter, or as agreed to by the lender.

At December 31, 2016, $181,692 remained outstanding under the note, which has been classified as current portion of long term debt and reported net of $952 of unamortized debt discount, and reported net of unamortized debt acquisition costs of $2,320.

At December 31, 2015, $901,876 remained outstanding under the note, which has been classified as $589,189 current portion of long term debt and $312,687 long term debt and reported net of $9,458 of unamortized debt discount, which has been reported as $8,506 short-term and $952 as long-term and reported net of unamortized debt acquisition costs of $23,048, which have been reported as $20,729 short-term and $2,320 as long-term.

**Term Notes:**

*PPI Bond Holder*

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 |
| (b) | 50% of each advance shall be used to repay amounts owed under the PPI Bond | |
| (c) | Interest Rate: | 12.25% per annum |
| (d) | Interest payments only: | June 30, 2013 through June 30, 2014 |
| (e) | Principal Repayment term: | 36 months (July 1, 2014 through June 20, 2017) |

The Company recorded debt acquisition costs of $70,437 which is being amortized over the life of the term note. In addition, the Company is accruing a back-end fee of $15,000 ratably over the life of the loan, payable in June, 2017.

At December 31, 2016, $75,288 remained outstanding under the note, which has been classified as current portion of long-term debt and reported net of unamortized debt acquisition costs of $984. As of December 31, 2016, the Company had net available funding of $305,000.

At December 31, 2015, $212,775 remained outstanding under the note, which has been classified as $137,487 current portion of long-term debt and $75,288 as long term debt and reported net of unamortized debt acquisition costs of $10,034, which have been reported as $9,051 short-term and $984 as long-term. As of December 31, 2015, the Company had net available funding of $305,000.

*Tiger Investments 1 LLC*

On June 20, 2013, the Company entered into a Term Loan agreement with a Lender, which is owned and controlled by the wife of Tim Losik, Patricia Losik. As Mr. Losik is a director and the Chief Executive of the Company, the entry into the Loan Facility constitutes a "related party transaction" for the purposes of AIM Rule 13.

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 |
| (b) | Interest Rate: | 12.25% per annum |
| (c) | Interest payments only: | June 30, 2013 through June 30, 2014 |
| (d) | Principal Repayment term: | 36 months (July 1, 2014 through June 20, 2017) |

The Company recorded debt acquisition costs of $165,817 which is being amortized over the life of the term note. In addition, the Company is accruing a back-end fee of $60,000 over the life of the loan, payable in June, 2017.

At December 31, 2016, $150,577 remained outstanding under the note, which has been classified as current portion of long-term debt and reported net of unamortized debt acquisition costs of $2,316. As of December 31, 2016, the Company had $1,220,000 available under this borrowing facility.

At December 31, 2015, $425,551 remained outstanding under the note, which has been classified as $274,974 current portion of long-term debt and $150,577 as long term debt and reported net of unamortized debt acquisition costs of $23,622, which have been reported as $21,306 short-term and $2,316 as long-term. As of December 31, 2015, the Company had $1,220,000 available under this borrowing facility.

**Barclays Bank, PLC**

On February 6, 2008, ProPhotonix Limited, a U.K. subsidiary, entered into a Confidential Invoice Discounting Agreement, as amended at various times, with Barclays Bank Sales Financing ("Barclays"). Under the Discounting Agreement, a three-year revolving line of credit was established. The facility requires the maintenance of certain financial covenants including a minimum tangible net worth.

On November 29, 2013, the Company entered into an amendment to the revolving credit facility to (i) increase the line from £650,000 to £1,400,000; (ii) to reduce the discount rate from 2.65% plus Barclays base rate to 2.50% plus Barclays base rate and service charges and extended the minimum period of this amendment to 24 months through November 29, 2015. The Company recorded debt acquisition costs of $27,172 which was fully amortized over the two year amendment period to November, 2015.

On February 10, 2016, the Company entered into an amendment to the revolving credit facility to (i) increase the line from £1,400,000 to £1,500,000; (ii) to reduce the discount rate from 2.50% plus Barclays base rate to 2.00% plus Barclays base rate and service charges (iii) increase the early payment ceiling from 80% to 85% and extended the minimum period of this amendment to 12 months through February 10, 2017 with a rolling evergreen provision.

The amount outstanding under the facility was $1,049,000 as of December 31, 2016 and $1,334,000 as of December 31, 2015 reported as a short term debt under revolving credit facility. As of December 31, 2016, the Company had approximately $394,000 available under this facility.

## (9) TAXES

The Company had deferred tax assets, before considering the full valuation allowance, totaling approximately $22.7 million as of December 31, 2016 and approximately $23.2 million as of December 31, 2015. 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 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 2001 through 2016 remain open to examination by the federal and most state tax authorities. The Company completed an IRS compliance audit for the 2012 tax year in 2015. In addition, the tax years 2010 through 2016 are open to examination in foreign jurisdictions.

The following is a reconciliation of the federal income tax provision calculated at the statutory rate of 34% to the recorded amount:

| | 2016 | 2015 |
|---|---|---|
| | In thousands | |
| **Years Ended December 31,** | | |
| Income (Loss) before taxes | $ 1,255 | $ 280 |
| Reconciliation | | |
| Applicable statutory federal income tax benefit | 427 | 95 |
| Foreign tax rate differential | (130) | (38) |
| Non deductible items | 28 | 33 |
| Valuation allowance | (325) | (90) |
| Net income tax provision | $ - | $ - |

The significant items comprising the deferred tax asset and liability at December 31, 2016 and 2015 are as follows:

| **Years Ended December 31,** | 2016 | 2015 |
|---|---|---|
| | In Thousands | |
| Domestic net operating loss carry forwards | $ 20,953 | $ 21,348 |
| Foreign net operating loss carry forwards | 1,236 | 1,504 |
| R&D tax credit | 525 | 525 |
| Other | 500 | 313 |
| Valuation allowance | (23,214) | (23,690) |
| Total | $ - | $ - |

As of December 31, 2016, the Company had United States federal net operating loss carry forwards (NOLs) of approximately $61.5 million (2015: $62.1 million) available to offset future taxable income, if any. These carry forwards expire through 2034 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, 2016, the Company also has Canadian federal NOLs of approximately $1.1 million (2015: $1.2 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. At December 31, 2016, the Company also has a United Kingdom NOL of approximately $3.4 million (2015: $4.4 million). At December 31, 2016, the Company also has an Ireland NOL of approximately $2.0 million (2015: $2.3 million). The total valuation allowance against deferred tax assets decreased by $0.4 million (2015: decreased by $0.2 million).

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, 2015, the Company had recorded a long-term liability of $178,000, relative to the 2009 sale of its North American operations which represented the only significant uncertain tax position of the Company. At December 31, 2016, management determined that this contingent liability no longer existed, as the audit period had lapsed, and reversed the liability to other income.

## (10) UNREGISTERED SALES OF EQUITY SECURITIES AND WARRANTS

Warrants

As of December 31, 2016, there were 4,456,067 common shares outstanding warrants with the following exercise prices and expiration dates:

| Number of Common Shares Warrants | Exercise Price | Expiration Date |
|---|---|---|
| 1,150,000 | $0.80 –$1.72 | 2017 |
| 906,067 | $0.45 –$0.60 | 2018 |
| 500,000 | $0.10 –$0.10 | 2019 |
| 1,900,000 | $0.03 | 2023 |
| 4,456,067 | | |

## (11) STOCK OPTION PLANS

On June 9, 2014, the Company implemented the creation of a 2014 stock incentive plan.

New remuneration policy for senior management

***Summary***

In order to incentivize the achievement of its objectives, the Company has implemented a new remuneration policy for its senior management with the following elements:

- A one-off substantial performance based option grant to key senior management at market value
- No further grants intended to said senior management through the end of the three-year measurement period
- Cliff vesting on December 31, 2016 at different levels dependent on achievement against the performance target (zero below 50% up to 100% vesting at 90% attainment)
- 10 year option term

***Performance measure -*** The performance measure is the driving factor behind the new policy. Broadly, the target is EBITDA (defined as earnings before interest, taxes, depreciation, amortization, and stock-based compensation) equal to 90% of the term debt and lease principal payments, and all interest payments, which are due during the performance period. Such payments would, on the basis of current obligations, amount to approximately $3.0 million in total. Achievement of this objective will result in full vesting. The committee and board believe that achievement of the objective will result in the creation of significant stockholder value.

Under the Company’s 2014 Stock Incentive Plan (the 2014 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 10,200,000 shares of the Company’s common stock were initially reserved for issuance under the 2014 Plan. In addition, there is an annual increase to the number of shares reserved for issuance under the 2014 Plan equal to the lesser of (i) 2,000,000 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.

Based on the Company's performance in relation to the target EBITDA as noted above, management has determined, and the Board of Directors has approved, that the performance achieved exceeds the 90% criteria, resulting in all performance option awards made in 2014 to senior management to become 100% exercisable and vested as of March 13, 2017. Total options vested under the EBITDA plan are 8,200,000.

As of December 31, 2016, there were 4,595,000 shares available to be issued from this plan.

In May, 2014, the Board of Directors approved the Seventh Amended and Restated Policy Regarding Compensation of Independent Directors, (i) cash compensation is $25,000 per annum paid in arrears each quarter in installments of $6,250; and (ii) options to purchase 150,000 shares of the Company's common stock, $.001 par value per share (the "Common Stock"), such that each Independent Director who is serving as director of the Company on the date of each annual meeting of stockholders (or special meeting in lieu thereof) beginning with the 2014 annual meeting, shall automatically be granted on such day an option (the "Option Award") entitling the recipient to acquire 150,000 shares of Common Stock, pursuant to the Company's 2014 Stock Incentive plan for 2015 & the 2007 Stock Incentive Plan (the "Plan") for 2014.

In May 2007, the Company adopted the 2007 Stock Option and Incentive Plan (the 2007 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 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, 2016. There is an intrinsic value on the options outstanding, and exercisable, at December 31, 2016 of $412,000 and $179,000, respectively. There was no intrinsic value on the options outstanding, and exercisable, at December 31, 2015.

During 2016 and 2015, 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 805,000 options granted during the year ended December 31, 2016 and there were 600,000 options granted during the year ended December 31, 2015. These options vest over a one year, or 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 weighted average assumptions for grants during the years ended December 31, 2016 and December 31, 2015 used in the Black-Scholes option pricing model were as follows:

| | Twelve months Ended December 31, 2016 | Twelve months Ended December 31, 2015 |
|---|---|---|
| Volatility……………………………………….. | 226.1% | 226.2% |
| Expected option life…………………………… | 7.8 years | 7.75 years |
| Interest rate (risk free)…………………………. | 1.69% | 2.01% |
| Dividends……………………………………. | $0 | $0 |
| Weighted average grant date fair value………... | $0.046 | $0.0314 |

| | **Options Outstanding** | **Weighted Average Exercise Price per Share** ($) | **Weighted Average Remaining Contractual Term (in Years)** |
|---|---|---|---|
| Balance at December 31, 2014 | 22,365,040 | 0.07 | 7.97 |
| Granted | 600,000 | 0.03 | |
| Exercised | - | - | |
| Cancelled | - | - | |
| Balance at December 31, 2015 | 22,965,040 | 0.07 | 7.03 |
| Vested and Exercisable at December 31, 2014 | 12,045,040 | 0.09 | 5.90 |
| Balance at December 31, 2015 | 22,965,040 | 0.07 | 7.03 |
| Granted | 805,000 | 0.05 | |
| Exercised | - | - | |
| Cancelled | (80,000) | 0.13 | |
| Balance at December 31, 2016 | 23,690,040 | 0.07 | 6.15 |
| Vested and Exercisable at December 31, 2016 | 13,810,040 | 0.09 | 5.15 |
| Vested and Expected to Vest at December 31, 2016 | 23,305,042 | 0.07 | 6.11 |

| Range of Exercise Prices | Options Outstanding | Weighted Average Contractual Life (years) | Weighted Average Exercise Price | Options Exercisable | Weighted Average Exercise Price |
|---|---|---|---|---|---|
| $ 0.02 – 0.99 | 23,690,040 | 6.2 | $ 0.07 | 13,810,040 | $ 0.08 |

At December 31, 2016, there was approximately $20,000 of total unrecognized compensation cost related to stock options granted (2015: $164,000). The cost is expected to be recognized over the next 1.30 years. Total stock option expense recorded in 2016 and 2015 was approximately $178,000 and $277,000, respectively. There were no options exercised during 2016 and 2015.

On January 10, 2017, there were 1,075,000 options exercised at an exercise price of $27,000, and having a market value of $85,000.

## (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, 2016 and 2015, there were no shares issued under the Stock Purchase Plan.

## (13) EMPLOYEE DEFINED CONTRIBUTION PLANS

On January 17, 1994, the Company established the ProPhotonix Limited 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 $28,000 in the year ended December 31, 2016 and $27,000 in the year ended December 31, 2015. The Company incurred costs of approximately $2,000 in 2016 and approximately $2,000 in 2015 to administer the Plan.  In 2015, approximately $15,000 of the $27,000 contributed by the Company was non cash, as the Company was allowed to offset these payments from the forfeitures remaining in the account, and as allowed by 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 $47,000 and $46,000 in the years ended December 31, 2016 and 2015.  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 $29,000 and $28,000 in the years ended December 31, 2016 and 2015, respectively.  Plan administration costs come out of the plan itself.

## (14) COMPANY FACILITIES, 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. On February 24, 2017, the Company signed a sixty one month lease, with an effective date of April 1, 2017, to lease 3,200 square feet in an office building, in Salem, New Hampshire, with an average monthly rate of $3,525 per month plus the tenant's share of expenses.

ProPhotonix (IRL) Limited rents approximately 10,000 square feet for its operations in Cork, Ireland. The original five year lease term ended on August 22, 2013 and the Company rents the space for its operations on a month to month basis. Base rent is €72,000 per year.

ProPhotonix Limited, a U.K. subsidiary, leases approximately 13,000 square feet of space in Hatfield Broad Oak, Hertfordshire, U.K. The original lease had a term of nine years ending September 29, 2013 at £87,000 per year, at which time the Company renegotiated the lease for an additional 3 years, ending September 30, 2016 at £70,000 per year. The Company has since renegotiated the lease for an additional 6 years at £75,000 per year. After September 2019, there is a rent review for the final 3 years of the lease. The Company has the option to terminate the lease with six months notice after September, 2017. A £10,000 penalty applies if this six month notice is prior to September 2019, but is penalty free after September 2019.

The Company utilizes, or has assumed, capital leases to finance purchases of equipment or vehicles. At December 31, 2016, the outstanding balance of capital leases was approximately $119,000 (£96,469) and at December 31, 2015, all capital leases were paid in full. The Company records depreciation expense on assets acquired under a capital lease in the consolidated statement of income.

The net book value of assets acquired under capital leases at December 31, 2016 and December 31, 2015, is as follows:

| | 2016 | 2015 |
|---|---|---|
| Assets under capital lease | $ 612,000 | $ 565,000 |
| Less—accumulated depreciation | (465,000) | (559,000) |
| Assets under capital lease, net | $ 147,000 | $ 6,000 |

Scheduled future minimum lease payments under non-cancelable operating leases and future capital lease payments for the next five years:

| Due by Period | 2017 | 2018 | 2019 | 2020 | 2021 | 2022+ | Total |
|---|---|---|---|---|---|---|---|
| | | | In thousands | | | | |
| Revolving Credit Facility | $1,049 | $- | $- | $- | $- | $- | $1,049 |
| Capital lease obligations | 68 | 51 | - | - | - | - | 119 |
| Operating lease obligations | 93 | 92 | 93 | 92 | 93 | 69 | 532 |
| | $1,210 | $143 | $93 | $92 | $93 | $69 | $1,700 |

The Company expensed approximately $206,000 and $217,000 in rent for the years ended December 31, 2016 and 2015, respectively.

## (15) 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.

## (16) GOVERNMENT GRANTS

In June 2016, the Company entered into an EU funded Fast Track to Innovation program to partner with other participants, including the end customer, in the development of a high power digital laser for a railway industry inspection system. The grant estimate is up to €360,000 with completion of the entire development project on June 1, 2018. During the year, the Company billed the EU program for a total of $42,000 of direct expenses for reimbursement, as well as $11,000 of indirect expenses for a total of $53,000. These amounts are reflected in the consolidated statement of income for 2016. In addition, the Company received advance funding totaling $285,000, which is reflected on the consolidated balance sheet.

## (17) SEGMENT INFORMATION

Operating segments are identified as components of an enterprise about which separate discrete financial information is available for evaluation by the chief decision-making group, in making decisions how to allocate resources and assess performance. The Company's chief decision-maker is the Chief Executive Officer. The Company's accounting policies and method of presentation for segments is consistent with that used throughout the consolidated financial statements.

The Company operates in two segments: LED's (light emitting diode systems) and Laser & Diodes. In the LED segment, the Company designs and manufactures LED systems for the inspection, machine vision, medical and military markets. The Laser & Diodes segment distributes laser diodes and designs and manufactures custom laser diodes modules for industrial, commercial, defense and medical applications. The policies relating to segments are the same as the Company's corporate policies.

The Company evaluates performance and allocates resources based on revenues and operating income. The operating profit / (loss) for each segment includes selling, research and development and expenses directly attributable to the segment. In addition, the operating profit includes amortization of acquired intangible assets, including any impairment of these assets and of goodwill. Certain of the Company's indirect overhead costs, which include corporate general and administrative expenses, are allocated between the segments based upon an estimate of costs associated with each segment. Segment assets include accounts receivable, inventory, machinery and equipment, goodwill and intangible assets directly associated with the product line segment.

| Years Ended December 31 | 2016 | 2015 |
|---|---|---|
| | (In thousands) | |
| Revenues: | | |
| LEDs | $ 6,802 | $ 6,578 |
| Laser & diodes | 9,443 | 7,833 |
| Total revenues | $ 16,245 | $ 14,411 |
| Gross profit: | | |
| LEDs | $ 3,276 | $ 3,136 |
| Laser & diodes | 4,107 | 2,834 |
| Total gross profit | $ 7,383 | $ 5,970 |
| Operating profit: | | |
| LEDs | $ 190 | $ 502 |
| Laser & diodes | 1,302 | 288 |
| Total operating profit | $ 1,492 | $ 790 |

| Years Ended December 31 | 2016 | 2015 |
|---|---|---|
| | (In thousands) | |
| Current assets: | | |
| LEDs | $ 2,060 | $ 1,659 |
| Laser & diodes | 2,641 | 2,729 |
| Corporate | 965 | 487 |
| Total current assets | $ 5,666 | $ 4,875 |
| Property, plant & equipment: | | |
| LEDs | $ 39 | $ 50 |
| Laser & diodes | 298 | 73 |
| Corporate | 5 | 9 |
| Total property, plant & equipment | $ 342 | $ 132 |
| Goodwill: | | |
| LEDs | $ 372 | $ 385 |
| Laser & diodes | — | — |
| Corporate | — | — |
| Total goodwill | $ 372 | $ 385 |
| Other assets: | | |
| LEDs | $ 69 | $ 76 |
| Laser & diodes | — | — |
| Corporate | 5 | 5 |
| Total other assets | $ 74 | $ 81 |
| Total assets: | | |
| LEDs | 2,540 | 2,170 |
| Laser & diodes | 2,939 | 2,802 |
| Corporate | 975 | 501 |
| Total assets | $ 6,454 | $ 5,473 |

| Years Ended December 31 | 2016 | 2015 |
|---|---|---|
| | (In thousands) | |
| Revenues by geographic area: | | |
| United States | $ 4,850 | $ 4,865 |
| Canada, Mexico & So. America | 1,932 | 1,048 |
| Europe | 7,777 | 6,703 |
| Asia & the rest of the world | 1,686 | 1,795 |
| Total | $ 16,245 | $ 14,411 |

The Company's long-lived assets consist of property, plant and equipment, goodwill and intangible assets located in the following geographic locations:

| Years Ended December 31 | 2016 | 2015 |
|---|---|---|
| | (In thousands) | |
| Long-lived assets by geographic area: | | |
| United States and North America | $ 5 | $ 9 |
| Europe | 411 | 435 |
| UK | 297 | 72 |
| Total | $ 713 | $ 516 |

## (18) SUBSEQUENT EVENTS

The Company has evaluated subsequent events through March 13, 2017, 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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