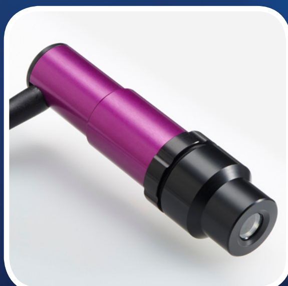
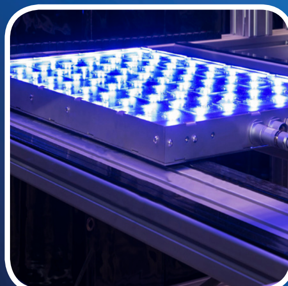
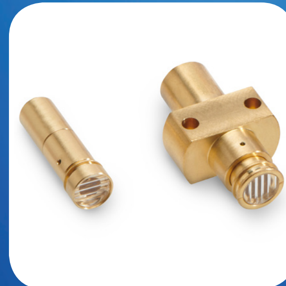
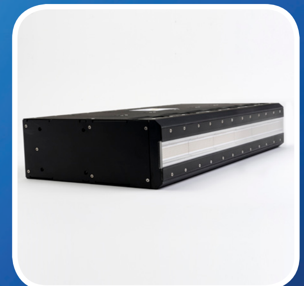
PRO PHOTONIX

Annual Report 2018

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

COBRA Cure FX1 Replaceable window
The COBRA Cure FX Series of UV LED Curing Systems incorporates a number of unique features designed to maximize performance and minimize downtime for users in the in industrial printing, 3D printing and adhesives curing market. The replaceable window design was recently awarded 2 US patents.

PROdigii High-Performance Digital Laser Module
The PROdigii digital laser module offers the precise control provided by the digital interface as well as integrated thermal control. The common digital interface allows great flexibility for the laser module to be optimized for a wide range of applications. In addition, the range of optical configurations available ensures the laser can be used in challenging 3D measurement applications such as railway infrastructure inspection as well as chemical and biomedical analysis.

New UV LED Testing Facilities at ProPhotonix (IRL) ltd.
ProPhotonix continues to invest in its UV LED product testing facilities to ensure it consistently delivers high quality UV LED products with repeatable performance.

Customized Compact Laser Modules
All of ProPhotonix' laser modules are designed to be configured to specific application requirements. Our in-house engineering team and production facilities enable further customization of our lasers platforms to suit customer needs.

COBRA Cure FX3 UV LED Curing System
ProPhotonix COBRA Cure FX3 delivers market leading intensity ensuring users in the print industry can run their lines faster. Pictured is a COBRA Cure FX3 scaled to suit the customers production line width.

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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 processes, 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.

2018 Annual Report to Shareholders

To the Shareholders of ProPhotonix Limited:

2018 was a challenging year for the Company with setbacks in revenue, gross profit, and net income. Though disappointing, our resolve to develop new products for target markets and customers remains unchanged. Technology developments resulted in the award of two patents in early 2019 relating to the UV LED products. The Horizon 2020 Innovation project funded by the European Union (EU) was completed from which our newest laser module device was created. We continue to make the necessary investments to achieve our business objectives.

Financial Summary:

As compared to 2017, sales decreased 8% to $16.4 million due in large part to the decline in business with one customer's delayed new product launch; gross profit decreased 20% primarily from unabsorbed manufacturing overhead due to the lower sales volume; and in 2018 the Company incurred an operating loss of $1.0 million compared to an operating profit of $1.2 million in 2017. The net profitability of the Company declined from $1.2 million in 2017 to a loss of $1.3 million while cash flow from operations was ($0.5 million) compared to $1.5 million in 2017. The decrease in revenue, gross profit, an increase in Selling, General, and Administrative costs of $0.4 million, a non-cash shift in Foreign Currency Exchange loss by $0.3 million from 2017 to 2018, and zero tax benefit in 2018 versus $0.5 million in 2017, all contributed to the lower profit profile of the Company.

The balance sheet remains consistent with the prior year with cash at year-end of $1.9 million (2017: $2.1 million) and a current ratio of 1.4 (2017: 1.6).

Customer and Product Development Initiatives:

During the year, the ProPhotonix engineering team completed the development of several products and implemented several new technology capabilities. The EU funded Fast Track to Innovation program ("Wheelwatcher"), a development project aimed at the train transport industry, was completed. This project enabled the Company to develop a digitally controlled, thermal electric cooled laser device; PROdigii™. Additional laser module features and capabilities were developed in coordination with the availability of new semiconductor diode lasers. The Company's ultra violet (UV) LED product range, Cobra Cure FX™ series, continues to evolve with additional features and technical capabilities. Prophotonix was recently awarded two patents for its UVLED technology by the United States Patent and Trademark Office. In addition, we continued to work with original equipment manufacturers ("OEM") in new product development efforts to help improve their products and processes.

Strategy:

The first part of our strategy relates to our existing customers and relationships. We consider these relationships vitally important and continue to work with customers to provide solutions to achieve their continued market success. Their success fuels our success and provides us the opportunity to develop new products and market solutions for other customers and applications. The second part of the Company's strategy remains established in its OEM heritage as well as the development of products directed at specific markets. ProPhotonix has made and will continue to make investments in commercially attractive OEM opportunities and product development including UV, multi-wavelength devices and laser technology advances, in the fulfillment of our strategies. We continue to concentrate our engineering capacity in defined projects and areas that we believe are poised for fast market expansion.

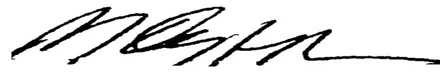
The first of these is the UV LED and UV laser market for various applications including: printing, curing, bonding, 3D printing, bio-luminescence, medical microscopy and other applications. The Company has launched several versions of its COBRA Cure™ product and continues to work with many potential customers in their applications using this technology. ProPhotonix has also developed its 405 nanometer diode laser capability with an extensive platform of devices and capabilities for the 3D printing, particle measurement, and sorting applications. We plan to continue to launch new higher power products while continuously enhancing our current product lines to serve this market during 2019 and beyond.

ProPhotonix also continues to focus on the market requirements 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, solar simulation and security markets. We intend to continue to enhance and expand this offering as market demand dictates.

Subsequent to year end, two Directors – Tim Steel and Mark Weidman – informed the board that their other commitments had resulted in them making the decision not to stand for re-election at ProPhotonix' forthcoming AGM. Both Tim and Mark have contributed mightily and distinctly to the success of ProPhotonix and on behalf of the Board, we would like to thank them for their many contributions.

In conclusion, we thank you; co-workers, customers, suppliers, service providers and investors for your continued support.

Respectfully submitted,



Tim Losik
President and Chief Executive Officer

Ray Oglethorpe
Non-Executive Chairman

REPORT OF DIRECTORS

FOR THE YEAR ENDED DECEMBER 31, 2018

The Directors present their report for the Company together with the financial statements for the year December 31, 2018. The financial statements are prepared under United States Generally Accepted Accounting Principles ("GAAP").

DIRECTORS' RESPONSIBILITIES FOR THE FINANCIAL STATEMENTS

The Directors are responsible for preparing the Report of the Directors and the financial statements in accordance with applicable requirements. The Directors have prepared the Company financial statements in accordance with United States Generally Accepted Accounting Principles ("GAAP"). The Directors will not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs and of the profit or loss of the Company for that year.

In preparing these financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and accounting estimates that are reasonable and prudent;
- state whether the applicable IFRSs have been followed, subject to any material departures disclosed and explained in the Company's financial statements; and
- prepare the financial statements on a going concern basis unless it is inappropriate to presume that the Company will continue in business.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company. They are also responsible for safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The Directors confirm that:

- so far as each Director is aware, there is no relevant audit information of which the Company's Auditor is unaware; and
- the Directors have taken all steps that they ought to have taken as Directors to make themselves aware of any relevant audit information and to establish that the Auditor is aware of that information.

The Directors are responsible for the maintenance and integrity of the corporate and financial information included on the Company's website.

AUDITOR

A resolution, approved by the Directors, to reappoint KPMG LLP as the Company's Auditor will be proposed at the forthcoming Annual General Meeting. In accordance with normal practice, the Directors will be authorized to determine the Auditor's remuneration. The Auditor's total remuneration for all services during 2018 was $115,000 of which $26,000 was not related to audit fees.

CORPORATE GOVERNANCE REPORT FOR THE YEAR ENDED DECEMBER 31, 2018

EFFECTIVE AND EFFICIENT GOVERNANCE
CHAIRMAN'S INTRODUCTION AND SUMMARY

It is the responsibility of the Chairman to oversee the Company's adoption, delivery and communication of appropriate corporate governance arrangements and to check that those arrangements are effective and efficient through regular review. Prior to 2018, as an AIM-listed company, ProPhotonix was not required to comply with any specific corporate governance code but we reviewed our arrangements against the UK Corporate Governance Code. The AIM Rules changed in 2018 and the Directors subsequently elected to adopt the principles of the Quoted Companies Alliance Corporate Governance Code for Small and Mid-Sized Companies (the "QCA Code") to the extent that the Directors consider it appropriate, and having regard to the Company's size, board structure, stage of development and resources. The QCA Code, sets out ten principles to be followed for companies to deliver growth in long term shareholder value, encompassing an efficient, effective and dynamic management framework accompanied by good communication to promote confidence and trust.

The ten principles of the QCA Code and the relevant section in this Annual Report that explains the Company's application of these principles are shown below:

1. **A strategy and business model which promotes long-term value creation for shareholders.**

   Business Activities (page 3)
   Letter to Shareholders (page 4-5)

2. **Understand and meet shareholder needs and expectations.**

   Investor Relations (page 8)

3. **Take into account wider stakeholder needs and social responsibilities and their implications for long-term success.**

   Corporate Culture, Stakeholder and Social Responsibilities (page 9)

4. **Embedded and effective risk management considering both opportunities and threats, throughout the organization.**

   Control Environment (page 9)
   Internal Control and Assessment of Business Risk (page 10-12)

5. **A well-functioning and balanced Board.**

   Board Overview (pages 13-14)
   Board of Directors (pages 15-16)

6. **Board experience, skills and capabilities.**

   Board Overview (pages 13-14)
   Board of Directors (pages 15-16)

7. **Performance of the Board and continuous improvement.**

   Board Overview (pages 13-14)

8. **Corporate culture based on ethical values and behaviors.**

   Corporate Culture and Social Responsibility (page 9)

9. **Effective governance structures which support good decision making.**

   Chairman's Introduction and Summary – Corporate Governance Report (page 7)
   Board Overview (pages 13-14)
   Board Committees (page 17)

10. **Communication of Company governance and performance.**

    Chairman's Introduction and Summary (page 7)
    Audit Committee Report (page 19)
    Governance, Nominations and Remunerations Committee Report (page 20-22)

INVESTOR RELATIONS

ProPhotonix seeks to maintain a regular dialogue with both existing and potential shareholders in order to communicate its strategy and progress and to understand the needs and expectations of shareholders.

Beyond the Annual General Meeting, the Chief Executive Officer and, where appropriate, other members of the senior management team meet regularly with investors and equity research analysts to provide them with updates on the business and to obtain feedback regarding the market's expectations of ProPhotonix.

ProPhotonix's investor relations activities encompass dialogue with both institutional and private investors.

The Board also endeavors to maintain a dialogue and keep shareholders informed through its public announcements and Company website (https://www.prophotonix.com/). ProPhotonix's website provides not only information specifically relevant to investors (such as the Company's annual report and accounts, investor presentations, regulatory announcements and share price information) but also regarding the nature of the business itself, the technology, key products and background to ProPhotonix's target markets and non-regulatory press releases.

CORPORATE CULTURE, STAKEHOLDER AND SOCIAL RESPONSIBILITIES

The Board places a high priority on regular communications with its various stakeholder groups and aims to ensure that all communications concerning the Company's activities are clear, fair and accurate. ProPhotonix's website is regularly updated and announcements or details of presentations and events are posted onto the website.

The Company engages regularly with various stakeholder groups, including shareholders, customers, suppliers and other market participants thereby ensuring that it remains up to date with key resources and relationships both out-with and within the business.

The Board seeks to maintain the highest standards of integrity and probity in the conduct of the Company's operations. These values are enshrined in the written policies and working practices adopted by all employees in the Company. An open culture is encouraged within the Company, with regular communications to staff regarding progress and staff feedback regularly sought. Senior management regularly monitors the Company's cultural environment and seeks to address any concerns than may arise, escalating these to Board level as necessary.

ProPhotonix is committed to providing a safe environment for its staff and all other parties for which the Company has a legal or moral responsibility in this area. The Company has a Health and Safety policy which is enforced rigorously.

CONTROL ENVIRONMENT

The Company has established operating procedures appropriate to its size and structure for reporting both financial and non-financial information to the Board. These include, but are not limited to:

- operating guidelines and procedures with approval limits;
- accounting policies, controls and procedures;
- performance monitoring systems updated monthly for review at Board meetings; and
- regulatory and legal changes that may materially impact on the business.

INTERNAL CONTROL AND ASSESSMENT OF BUSINESS RISK

The systems for internal control and risk management processes are designed to manage and mitigate risks that may impact achievement of the Company's strategic objectives. Such systems can only provide a reasonable but not absolute level of assurance against material misstatement or loss. The Company's overall risk assessment process is facilitated by the CEO, who runs monthly operational progress meetings and holds and appraises the Corporate Risk Register (CRR) at least once a year. Once the review has concluded the revised CRR is forwarded to the Board, which assesses the updated register and confirms the key risks.

PRINCIPAL RISKS AND UNCERTAINTIES

The Board regularly considers those risks that might impact performance of the Company, including at least annually in preparing this Annual Report, and will monitor mitigating actions being taken.

The key business and financial risks for the Company are set out below:

General notice of Risk	As part of the process for admission to AIM, the Company reviewed and updated its principal risks and uncertainties as discussed in the Company's Admission Document. Business risks were considered again by the Board in preparing this Annual Report and those considered most important are set out below and should be considered with those risks described in the Admission Document. As part of the Company's structured risk management process, the Board will regularly consider those risks that might impact performance of the Company and will monitor mitigating actions being taken.

RISK AREA	RISK/MITIGATION
Strategic	**Customer concentration**. At times the Company is exposed to concentration of revenue in its customer base. This was the case where two customers represented approximately 20% of total revenue in 2017 but which did not sustain the same level of business in 2018. While customer concentration will change during any financial period, the loss of any of the key client could have a material impact on the Company's financial results. The Company is reliant on the long-term commercial success of its clients. Underperformance of the Company's clients could have a material adverse effect on the Company's business, operations, revenues or prospects. The Company looks to mitigate such risks through having strong relationships with its current customers and by attracting new clients.
	Competition. The businesses of the Company operate in highly fragmented industries where there are not only many competitors but also dominant market leaders. The Company seeks to mitigate such risks through superior technology, flexibility and speed with which to conduct business, and close working relationships with its customers.
	Intellectual property. The Company relies on a combination of patent, trade secret, copyright, non-disclosure laws and other contractual agreements and technical measures to protect its own and its customers' intellectual property. The Company has entered into confidentiality provisions as part of its arrangements with its employees and consultants. Despite the Company's efforts to protect its proprietary rights, unauthorized third parties may attempt to copy or use information from technologies and products of the Company. If the Company cannot successfully enforce its intellectual property rights or if a client's intellectual property is damaged, this could have a material adverse effect on the Company's business, financial condition and prospects.

PRINCIPAL RISKS AND UNCERTAINTIES (continued)

Financial

Going Concern. While the Company has been in existence for more than 60 years, there have been periods where it has incurred losses for several years at a time. The Company historically operates with thin profit margins. The Company mitigates this risk in several ways: Access to capital via the Sales Finance Facility with Barclays, its relationship with SQN Capital - a lender to the Company, and relationships with equity investors. If the Company is unable to secure financing when needed it could have a material adverse impact on the financial condition of the business.

Operational

Ability to recruit and retain skilled personnel. The Company's operational and financial performance is dependent upon its ability to attract and retain effective personnel. The Directors believe that the Company has in place the appropriate remuneration and other incentivization structures and processes to attract and retain the caliber of employees necessary to ensure the efficient management and development of the Company. However, any difficulties encountered in hiring and retaining appropriate employees and the failure to do so may have a detrimental effect upon the trading performance of the Company. The ability to attract and retain employees with the appropriate expertise and skills cannot be guaranteed. This risk may be exacerbated by the uncertainty surrounding Brexit.

Management Infrastructure. Due to the size of the Company, there are several individuals/functions that are single points of management. As such, the departure of a particular employee may cause disruption or dislocation to the business. Where possible, the Company seeks to create a matrix of skills between various individuals to provide overlapping cover while it seeks to replace a departing employee.

Brexit. Risks associated with Brexit include consumer and customer confidence, tariff and logistics impact, foreign exchange rate risk, availability and cost of certain materials, and availability of European employees. Whilst the full business implications of Brexit remain uncertain, and will do for some time, the Board believes the Company is well positioned to react to the potential challenges and opportunities ahead.

BOARD OVERVIEW

The Board is responsible for the long-term growth and profitability of ProPhotonix Limited. Among its responsibilities it works with management to set corporate values and to develop strategy, including deciding its risk management policy and financial objectives.

A schedule of matters reserved for the Board's resolution details key aspects of the Company's affairs that are not delegated beyond the Board (including, among other things, approval of business plans and budgets, material expenditure and alterations to share capital).

The matters reserved for the attention of the Board include:

- overall business strategy;
- review of key operational and commercial matters;
- review of key finance matters, including approval of financial budgets, changes to capital structure, acquisitions and disposals of businesses, material capital expenditure and dividends;
- governance: Board membership and powers including the appointment and removal of Board members, the set-up and delegation of matters to appropriate Committees, and the reviewing of reporting back thereof;
- approval of financial statements, both interim and year end;
- stock exchange related issues including the approval of communications to the stock exchange and communications with shareholders in conjunction with any financial public relations firm;
- subsidiary board appointments, as the 100% shareholder, and review of key decisions at their board meetings;
- approval of acquisitions, disposals, borrowing facilities, premises and matters proposed by the corporate lawyer and nominated advisor and broker;
- appointment and performance review of key advisors; and
- approval of letters of recommendation for the Employee Benefit Trust in respect of the operation of share option schemes.

The Board seeks to meet regularly during the year and the entire Board is invited to attend all meetings. In the financial year to December 31, 2018 the Board met on five occasions. At least two meetings a year have extended time allowed where the focus is predominantly on core strategic issues.

The Chairman and the Company CEO plan the agenda for each Board meeting in consultation with all other Directors. The agenda is issued with supporting papers ahead of the Board meetings, along with appropriate information required to enable the Board to discharge its duties.

CORPORATE GOVERNANCE REPORT 2018 (continued)
BOARD OVERVIEW (continued)

Matters referred to the Board are considered by the Board as a whole and no one individual has unrestricted powers of decision.

Where Directors have concerns, which cannot be resolved in connection with the running of the Company or a proposed action, their concerns would be recorded in the Board minutes. This course of action has not been required to date. The Directors can obtain independent professional advice at the Company's own expense in performance of their duties as Directors.

The composition of the Board of Directors is shown on pages 15 and 16. The Board of ProPhotonix is currently comprised of five Directors: the Non-Executive Chairman, three further Non-Executive Directors and the Chief Executive Officer, though as noted above, Tim Steel and Mark Weidman two of our current Non-Executive Directors, will not seek re-election to the Board at Prophotonix' AGM. As per the individual biographies, the Directors have a range of experience and provide a balance of skills, experience and knowledge to the Board.

The Board, led by the Chairman, periodically reviews the overall performance of the Board and makes adjustments to ensure the structure and focus of the Board meet the evolving requirements of the Company. The Board currently does not practice an annual review of each Board member and will continue to evaluate this aspect of the QCA.

All Directors are subject to election at the first Annual General Meeting following their appointment and to re-election annually thereafter.

The Chairman and Chief Executive have distinct roles; the principle responsibility of the Chairman is the effective operation of the Board of Directors, whilst the Chief Executive is responsible for the operation of the Company to deliver on its strategic objectives.

The role of the Company Secretary is to ensure reliable and regular information flows to the Board and its Committees and to ensure applicable rules and regulations are followed. The Company Secretary is available to all Directors to provide advice and assistance and is responsible for providing governance advice to the Board.

The Board considers all four Non-Executive Directors (the Non-Executive Chairman and the three Non-Executive Directors) to be independent in terms of their ability to make unencumbered decisions for the long-term success of the Company:

Timothy "Tim" Paul Losik
President and Chief Executive Officer (CEO)

Mr. Losik was appointed as President and CEO of ProPhotonix in 2013, and has been a member of the board since 2010. From 2008, Mr. Losik held the positions of COO and CFO of ProPhotonix with responsibility for all day-to-day operations across the Company's worldwide operating units and to head its financial organization. Prior to joining the Company, Mr. Losik held senior operating and/or financial executive positions for various publicly listed and private enterprises (primarily in the technology sector).

Raymond "Ray" Joseph Oglethorpe
Non-Executive Chairman

Mr. Oglethorpe is currently President of Oglethorpe Holdings, LLC, a private investment company, and has served as a board director on numerous public and private companies. Mr. Oglethorpe served as President of America Online, Inc. from 2000 until his retirement in 2002. Prior to that time, Mr. Oglethorpe was a senior vice president responsible for directing the technologies and member services organizations of America Online, Inc. Mr. Oglethorpe has been a member of the Board since 2000 and is a member of both the Governance, Nominations and Remuneration committee and Audit committee.

Timothy "Tim" Michael Steel
Non-Executive Director

Mr. Steel was previously Vice Chairman of Cazenove Capital Management Limited until the end of 2009 when he stepped down to pursue a portfolio career and work more closely with smaller developing businesses. He joined Cazenove in 1980 from Robert Fleming and became a partner in 1982. In 1983 he moved to New York as President of Cazenove Inc., returning to the UK in 1989 and, subsequently became Head of Institutional Broking in 1991. He was appointed Managing Director of Cazenove Fund Management Limited in February 2000 and later became Chairman in April 2001. He was appointed to the main Board of Cazenove Group plc in March 2001. Mr. Steel is currently Chairman of Castle Alternative Invest AG, Chairman of Committed Capital Limited, a private equity firm, and is Chairman of WH Ireland, a financial services company. He is the chairman of the Governance, Nominations and Remuneration committee and a member of the Audit committee.

Gerald Vincent “Vincent” Bodenham Thompson
Non-Executive Director

Mr. Thompson has over 30 years of experience in corporate finance. He spent the majority of his career with Morgan Grenfell & Co. Limited and Hambros Bank Limited (later Société Générale, following the takeover of Hambros Bank Limited) and was a Director at both. From 2003 to 2006 he was a Director at MacArthur & Co. Limited and from 2007 to 2008, was an Associate of Corbett Keeling & Co, both corporate finance boutiques. In 2009, Mr. Thompson formed his own corporate finance boutique, Easton Partners LLP. In June 2018, Mr. Thompson became a Non-Executive Director of SANDAIRE Limited, a financial services company. He is chairman of the Audit committee and a member of the Governance, Nominations and Remuneration committee.

Mark Weidman
Non-Executive Director

Mark Weidman is currently the CEO of Harvest Power Inc., a Waltham, Massachusetts based company engaged in the environmental services sector and specializing in converting waste organics into valuable consumer products and energy. Mark is also an operating partner at True North Venture Partners and the founder and owner of Birch Tree Environmental Group, LLC, a consulting firm providing services in the environmental services, energy and technology sectors. Mr. Weidman previously served as President and CEO of Wheelabrator Technologies Inc., a world-leading environmental technologies company, from 2006 to July 2015. Prior to 2006, Mr. Weidman served in senior executive positions with Wheelabrator, and Wheelabrator Bio Gro. Mr. Weidman has been a member of the Board of the Company since July 2013 and is a member of both the Governance, Nominations and Remuneration committee and Audit committee.

A summary of Board and Committee meetings attended in the year ended December 31, 2018 is set out below:

	Meetings	Member Attendance
Board	5	100%
Audit Committee	4	100%
Governance, Nomination, Remuneration Committee	2	100%

BOARD COMMITTEES

Two committees of the Board provide oversight to support the proper governance of the Company:

The Audit Committee is responsible for providing formal and transparent reporting of the financial performance of the Company for applying internal control principles and for maintaining an appropriate relationship with the company's auditors.

The Governance, Nominations and Remuneration Committee is responsible for oversight of corporate and director governance, identifying, evaluating and recommending qualified director candidates to the Board, and overseeing remuneration of the individual directors and management

AUDIT COMMITTEE

The Audit Committee comprises only independent Non-Executive Directors and is supported by Edward Dolan, CFO. The Audit Committee determines the terms of engagement of the Company's Auditor and, in consultation with the Auditor, the scope of the audit. It will receive and review reports from management and the Auditor relating to the interim and annual accounts as well as the accounting and internal control systems in use by the Company and the Group. The Audit Committee has unrestricted access to the Company's Auditor. The Audit Committee also reviews accounting and treasury policies, financial reporting including key performance indicators and supporting key areas of management judgements, and corporate governance standards. In the financial year to December 31, 2018 the Audit Committee met on four occasions, and all four meetings were attended by the external Auditor (KPMG).

GOVERNANCE, NOMINATIONS AND REMUNERATION COMMITTEE

The Governance, Nominations and Remuneration Committee comprises only independent Non-Executive Directors and is supported by Edward Dolan, CFO. The Committee reviews the scale and structure of the Non-Executive Directors' and Executive Directors' future remuneration and the terms of the service agreements with due regard to the interests of shareholders. No Director is permitted to participate in discussions or decisions concerning their own remuneration. The Remuneration Committee also approves annual salary review limits, bonus schemes and payment limits, in addition to significant employee benefits, such as pensions, medical insurance and share option schemes. The Committee reviews the constituents of the Board and its Committees to ensure appropriate balanced representation.

AUDITOR INDEPENDENCE

ProPhotonix' external Auditor is KPMG LLP, which has served the Company since September 2012. The external audit function provides independent review and audit. It is the responsibility of the Audit Committee to review and monitor the external Auditor's independence, objectivity and the effectiveness of the audit process, taking into consideration relevant professional and regulatory requirements as well as developing and implementing policy on the engagement of the external Auditor to supply non-audit services.

The Audit Committee monitors procedures to ensure the rotation of external audit partners every five years and audit managers every seven years.

SENIOR MANAGEMENT AND COMPANY FUNCTIONS

ProPhotonix' senior management is involved in multiple functions within the Company. It is responsible for reviewing the overall organizational structure of the Company, as well as refining and implementing the recruitment and retention program in order to identify and hire the right candidates as required in addition to retaining existing staff members.

AUDIT COMMITTEE REPORT

The Audit Committee was established in accordance with Section 3(a)(58)(A) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") and in accordance with the UK Corporate Governance Code and consists of Messrs. Raymond J. Oglethorpe, Timothy Steel, Vincent Thompson and Mark Weidman, each of whom have been determined by the Board of Directors to be an "independent director", as defined in Nasdaq Rule 5605(a)(2), to satisfy the heightened independence requirements of the Securities and Exchange Commission (the "SEC") applicable to all members of a registrant's Audit Committee and to otherwise satisfy the applicable audit committee membership requirements promulgated by the SEC and the QCA Code. In addition, each member of the Audit Committee satisfies the independence requirements of the UK Corporate Governance Code. The Audit Committee acts pursuant to the Amended and Restated Audit Committee Terms of Reference, a copy of which is available by clicking "Audit Committee" on the "Committee Assignments" page of the Corporate Governance section of the Investors page of the Company's website at www.prophotonix.com. During the fiscal year ended December 31, 2018, the Audit Committee met four times.

The Audit Committee assists the Board of Directors in fulfilling its responsibilities to stockholders concerning the Company's financial reporting and internal controls, oversees the Company's independent registered public accounting firm and facilitates open communication among the Audit Committee, the Board of Directors, the Company's independent registered public accounting firm and management. The Audit Committee discusses with management and the Company's independent registered public accounting firm the financial information developed by the Company, the Company's systems of internal controls and the Company's audit process and various matters relating to the results of the annual audit of the Company. The Audit Committee is directly responsible for appointing, evaluating, retaining, and, when necessary, terminating the engagement of the independent registered public accounting firm who will conduct the annual audit of the financial statements of the Company. The Audit Committee is also responsible for pre-approving all audit services, as well as all review, attest and non-audit services to be provided to the Company by the Company's independent registered public accounting firm. The Audit Committee oversees investigations into complaints received by any member of the Board of Directors or employee of the Company regarding accounting, internal accounting controls or auditing matters. The Audit Committee reviews all related party transactions on an ongoing basis, and all such transactions must be approved by the Audit Committee. The Audit Committee is authorized, without further action by the Board of Directors, to engage such independent legal, accounting and other advisors as it deems necessary or appropriate to carry out its responsibilities.

AUDIT COMMITTEE
Vincent Thompson (Chair)
Raymond J. Oglethorpe
Timothy Steel
Mark Weidman

GOVERNANCE, NOMINATIONS AND REMUNERATIONS COMMITTEE REPORT

The GNR Committee consists of Messrs. Raymond J. Oglethorpe, Vincent Thompson, Timothy Steel and Mark Weidman, each of whom have been determined by the Board of Directors to be an "independent director", as defined in Nasdaq Rule 5605(a)(2), and to otherwise meet the nominating and compensation committee membership requirements promulgated by the SEC and Nasdaq. In addition, each member of the GNR Committee satisfies the independence requirements of the QCA Code. The GNR Committee acts pursuant to the Governance, Nominations and Remuneration Committee Terms of Reference, a copy of which is available on the "Committee Assignments" page of the Corporate Governance section of the Investors page of the Company's website at www.prophotonix.com. The GNR Committee met two times during the fiscal year ended December 31, 2018.

With respect to corporate governance matters, the GNR Committee is responsible for establishing and monitoring the adequacy of, and the Company's compliance with, policies and processes regarding principles of corporate governance, monitoring and taking appropriate action with respect to corporate governance requirements of the SEC and the QCA Code, and reviewing and recommending appropriate action to the Board with respect to all stockholder proposals submitted to the Company.

With respect to director nomination matters, the GNR Committee is responsible for establishing qualifications to be considered when evaluating candidates for nomination for election to the Board of Directors and appointment to the committees thereof. In addition, the GNR Committee is responsible for identifying, evaluating and recommending qualified director candidates to the Board of Directors and its committees for nomination or appointment, as the case may be, evaluating the continued qualification of directors nominated for re-election, and annually reviewing the composition of the Board to ensure that the directors, as a group, provide a significant breadth of experience, knowledge and abilities to the Board.

Whilst the Board does not currently adopt a regular and formal appraisal process for each of the Directors, the Board does monitor the Non-executive Directors' status as independent to ensure a suitable balance of independent Non-executive and Executive Directors remains in place. In addition, the Board considers on a regular basis, the adequacy of the composition of the Board and at least annually, succession planning.

The GNR Committee generally assists the Board of Directors with respect to matters involving the compensation of the Company's directors and executive officers, oversight of corporate governance matters and identifying individuals qualified to become members of the Board. The responsibilities of the GNR Committee with respect to director and executive officer compensation include determining salaries and other forms of compensation for the Chief Executive Officer and the other executive officers of the Company, reviewing and making recommendations to the Board with respect to director compensation, periodically reviewing and making recommendations to the Board with respect to the design and operation of incentive-compensation and equity-based plans and generally administering the Company's equity-based incentive plans. Director compensation is described in Footnote 11 to the Financial Statements on page 48. The GNR Committee may form, and delegate authority to, one or more subcommittees as it deems appropriate under the circumstances. In addition, to the extent permitted by applicable law and the provisions of a given equity-based incentive plan, the GNR Committee may delegate to one or more executive officers of the Company the power to grant options or other stock awards pursuant to such plan to employees of the Company or any subsidiary of the Company who are not directors or executive officers of the Company. Historically, the Chief Executive Officer and Chief Financial Officer, in consultation with the GNR Committee and within certain per-person and per-year limits established by the GNR Committee, have been authorized to make limited stock option grants to non-executive officers of the Company.

The Company's Chief Executive Officer generally makes recommendations to the GNR Committee regarding the compensation of other executive officers. In addition, the Chief Executive Officer is often invited to attend GNR Committee meetings and participates in discussions regarding the compensation of other executive officers, but the GNR Committee ultimately approves the compensation of all executive officers. Other than making recommendations and participating in discussions regarding the compensation of other executive officers, the Company's Chief Executive Officer generally does not play a role in determining the amount or form of executive compensation. Except for the participation by the Chief Executive Officer in meetings regarding the compensation of other executive officers, the GNR Committee meets without the presence of executive officers when approving or deliberating on executive officer compensation.

Director Compensation for the year ended December 31, 2018 and 2017 (audited)

Executive Director	Salary ($)	Bonus ($)	Pension ($)	Other (1) ($)	Total Cash Compensation ($)	Options ($)	Total All Compensation 2018 ($)
Tim Losik	325,750		6,125	-	331,875	387,755	719,630
Total Executive Director Compensation (2)	**325,750**		**6,125**	-	**331,875**	**387,755**	**719,630**
Non-Executive Director							
Ray Oglethorpe	-	-	-	41,972	41,972	-	41,972
Timothy Steel	-	-	-	41,972	41,972	-	41,972
Vincent Thompson	-	-	-	41,972	41,972	-	41,972
Mark Weidman	-	-	-	41,972	41,972	-	41,972
Total Non-Executive Director Compensation	-	-	-	**167,888**	**167,888**	-	**167,888**

Director Share Options:

Director	Options @ 12/31/17	Options Granted	Options Forfeited	Options Exercised	Options @ 12/31/18
Tim Losik	6,650,000	-	(100,000)	-	6,550,000
Ray Oglethorpe	2,109,006	-	(79,710)	-	2,029,296
Timothy Steel	1,595,433	-	-	-	1,595,433
Vincent Thompson	1,595,433	-	-	-	1,595,433
Mark Weidman	450,000	-	-	-	450,000
Total All Directors	**12,399,872**	-	**(179,710)**	-	**12,220,162**

(1) Other compensation for non-executive directors represents cash payments expensed for quarterly Board fees of $7,500 per quarter in the current year, plus the value of the fully vested shares issued in May 2018 and 2017. See Note 11 to the Financial Statements for more detail related to the fully vested shares.

(2) Executive Director Compensation is reviewed by the Independent Non-Executive Directors

GOVERNANCE, NOMINATIONS AND REMUNERATIONS COMMITTEE REPORT (continued)

Executive Director	Salary ($)	Bonus ($)	Pension ($)	Other (3) ($)	Total Cash Compensation ($)	Options ($)	Total All Compensation 2017 ($)
Tim Losik	326,500	60,000	6,000	-	392,500	226,191	618,691
Total Executive Director Compensation (4)	**326,500**	**60,000**	**6,000**	**-**	**392,500**	**226,191**	**618,691**
Non-Executive Director							
Ray Oglethorpe	-	-	-	37,313	2,855	-	40,168
Timothy Steel	-	-	-	37,313	2,855	-	40,168
Vincent Thompson	-	-	-	37,313	2,855	-	40,168
Mark Weidman	-	-	-	37,313	2,855	-	40,168
Total Non-Executive Director Compensation	**-**	**-**	**-**	**149,252**	**11,420**	**-**	**160,672**

(3) Other compensation for non-executive directors represents cash payments expensed for quarterly Board fees of $7,500 per quarter in the current year, plus the value of the fully vested shares issued in May 2017. See Note 11 to the Financial Statements for more detail related to the fully vested shares.

(4) Executive Director Compensation is reviewed by the Independent Non-Executive Directors

ProPhotonix Limited

Consolidated Financial Statements

Years Ended December 31, 2018 and 2017

CONSOLIDATED FINANCIAL STATEMENTS

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Independent Auditors' Report

The Board of Directors
ProPhotonix Limited

We have audited the accompanying consolidated financial statements of ProPhotonix Limited and its subsidiaries, which comprise the consolidated balance sheets as of December 31, 2018 and 2017, 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.

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, 2018 and 2017, and the results of their operations and their cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.

The impact of uncertainties due to the UK exiting the European Union on our audit

Uncertainties related to the effects of Brexit are relevant to understanding our audit of the financial statements. All audits assess and challenge the reasonableness of estimates made by the directors, such as impairment of assets and related disclosures and the appropriateness of the going concern basis of preparation of the financial statements. All of these depend on assessments of the future economic environment and the company's future prospects and performance.

Brexit is one of the most significant economic events for the UK, and at the date of this report its effects are subject to unprecedented levels of uncertainty of outcomes, with the full range of possible effects unknown. We applied a standardised firm-wide approach in response to that uncertainty when assessing the company's future prospects and performance. However, no audit should be expected to predict the unknowable factors or all possible future implications for a company and this is particularly the case in relation to Brexit.

KPMG LLP

KPMG LLP

Altius House
One North Fourth Street
Central Milton Keynes
MK9 1NE
United Kingdom

April 5, 2019

PROPHOTONIX LIMITED

CONSOLIDATED BALANCE SHEETS

($ In thousands except share and per share data)

December 31	2018	2017
Assets		
Current assets:		
Cash and cash equivalents	$ 1,939	$ 2,150
Accounts receivable, less allowances of $49 in 2018 and $14 in 2017	2,872	3,114
Inventories, less allowances of $615 in 2018 and $633 in 2017 (Note 4)	2,399	2,280
Prepaid expenses and other current assets	289	235
Total current assets	7,499	7,779
Net property, plant and equipment (Note 5)	646	633
Deferred tax assets (Note 9)	454	475
Goodwill (Note 6)	405	424
Other long-term assets	423	239
Total assets	**$ 9,427**	**$ 9,550**
Liabilities and Stockholders' Equity		
Current liabilities:		
Revolving credit facility (Note 8)	$ 1,096	$ 1,293
Current portion of long-term debt (Note 8)	188	-
Accounts payable	1,791	1,638
Accrued payroll, benefits and incentive compensation	399	636
Deferred revenue	498	434
Accrued warranty expenses	170	184
All other accrued expenses	270	534
Current portion of capital lease obligations	63	95
Total current liabilities	4,475	4,814
Long term debt obligations, net of current portion (Note 8)	581	-
Long term capital lease obligations, net of current portion	94	98
Total liabilities	**5,150**	**4,912**
Stockholders' Equity:		
Common stock, par value $0.001; shares authorized 250,000,000 at December 31, 2018 and at December 31, 2018; 93,000,402 shares issued and outstanding at December 31, 2018 and 92,565,402 shares issued and outstanding at December 31, 2017	93	93
Additional paid-in capital	114,067	112,987
Deferred compensation	(19)	(18)
Accumulated deficit	(110,746)	(109,438)
Accumulated other comprehensive income	882	1,014
Total stockholders' equity	**4,277**	**4,638**
Total liabilities and stockholders' equity	**$ 9,427**	**$ 9,550**

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, 2018	Years Ended December 31, 2017
Revenue	$ 16,401	$ 17,743
Cost of Revenue	(10,057)	(9,822)
Gross Profit	6,344	7,921
Research & Development Expenses	(1,011)	(763)
Selling, General & Administrative Expenses	(6,327)	(5,951)
Operating (Loss) Income	(994)	1,207
Other Income, net	20	375
Foreign Currency Exchange (Losses) Gains	(232)	57
Warrant & Debt Acquisition Expense	(11)	(18)
Interest Expense	(91)	(49)
(Loss) Income Before Taxes	(1,308)	1,572
Income Tax Benefit	-	469
Net (Loss) Income	$ (1,308)	$ 2,041
Other Comprehensive Income:		
Foreign currency translation	(132)	51
Total Comprehensive (Loss) Income	$ (1,440)	$ 2,092

	2018	2017
Net (Loss) Income Per Share: Basic and diluted:		
Basic net (loss) income per share	$(0.014)	$0.022
Diluted net (loss) income per share	$(0.014)	$0.020
Shares used in per share calculations - Basic	92,782,902	92,565,402
Shares used in per share calculations - Diluted	92,782,902	104,193,859

See the notes to consolidated financial statements.

PROPHOTONIX LIMITED

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(In thousands)

	Common Stock						
	Shares	Par $0.001	Paid in Capital	Deferred Compensation	Accumulated Deficit	Accumulated Other Comprehensive Income	Total Stockholders' Equity
Balance December 31, 2016	**83,665**	**$84**	**$112,038**	**-**	**($111,479)**	**$963**	**$1,606**
Net profit	-	-	-	-	2,041	-	2,041
Translation adjustment	-	-	-	-	-	51	51
Exercise of options	6,700	7	231	-	-	-	238
Exercise of warrants	1,900	2	55	-	-	-	57
Deferred compensation	300	-	47	(47)	-	-	-
Share based compensation	-	-	616	29	-	-	645
Balance December 31, 2017	**92,565**	**$93**	**$112,987**	**($18)**	**($109,438)**	**$1,014**	**$4,638**
Net loss	-	-	-	-	(1,308)	-	(1,308)
Translation adjustment	-	-	-	-	-	(132)	(132)
Exercise of options	135	-	4	-	-	-	4
Deferred compensation	300	-	49	(49)	-	-	-
Share based compensation	-	-	1,027	48	-	-	1,075
Balance December 31, 2018	**93,000**	**$93**	**$114,067**	**($19)**	**($110,746)**	**$882**	**$4,277**

See the notes to consolidated financial statements.

PROPHOTONIX LIMITED

CONSOLIDATED STATEMENTS OF CASH FLOWS

($ In thousands)

Years Ended December 31	**2018**	**2017**
Cash flows from operating activities		
Net (loss) income	**$ (1,308)**	**$ 2,041**
Adjustments to reconcile net income to net cash provided by operating activities:		
Stock-based compensation expense	1,075	645
Depreciation	169	100
Foreign exchange loss (gain)	77	(264)
Amortization of debt discount and financing costs	10	7
Allowance for inventories	5	33
Allowance for bad debt	37	5
Other changes in assets and liabilities:		
Accounts receivable	68	(553)
Inventories	(235)	141
Prepaid expenses and other current assets	(62)	97
Deferred tax asset	-	(475)
Accounts payable	233	(11)
Accrued expenses	(389)	(150)
Other assets and liabilities	(183)	(164)
Net cash (used in) provided by operating activities	**(503)**	**1,452**
Investing		
Purchase of property, plant and equipment	(200)	(170)
Net cash used in investing activities	**(200)**	**(170)**
Financing		
Proceeds from exercise of options and warrants	4	295
Net proceeds from issuance of debt	875	-
Borrowings of revolving credit facilities, net	(151)	96
Payments for capital leases	(138)	(81)
Principal repayment of long-term debt	(88)	(449)
Net cash provided by (used in financing activities)	**502**	**(139)**
Effect of exchange rate on cash	(10)	96
Net change in cash and equivalents	(211)	1,239
Cash and equivalents at beginning of period	2,150	911
Cash and equivalents at end of period	**$ 1,939**	**$ 2,150**
Supplemental cash flow information:		
Cash paid for interest	**$ 91**	**$ 49**

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 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 Company's common stock, $.001 par value per share (the "Common Stock"), 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, 2018 and 2017, the Company recorded a net loss in 2018 and net income in 2017 of $(1.5 million) and $2.0 million, respectively. Net cash used in and provided by operating activities for the same time periods were $(0.5 million) and $1.5 million, 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. At December 31, 2018, the company had breached a calculated debt covenant calculation on our term debt. Subsequent to year end the company has obtained a waiver from SQN stating the term debt will not be called. Cash flow forecasts indicate the Company can continue to operate for at least the next twelve months even when reasonable downward sensitivities are taken into account. Forecasts indicate no future breaches of covenants in respects to the term loan facility. The Company has renewed its Barclays facility related to invoice discounting (See Note 8).

(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. In preparing these consolidated financial statements, management has made judgments, estimates, and assumptions that affect the reported amounts of assets, liabilities, income, and expenses. Actual results may differ from those estimates. Estimates and underlying assumptions are reviewed on an on-going basis for items such as revenue recognition where long term contracts are entered into, recognition of deferred tax assets, inventory allowances, warranty provisions and accruals. Revisions to estimates are recognized prospectively.

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.

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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 accounts receivables in excess of 60 days past invoice due date. The Company has not made any claims in either 2018 or 2017. 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	**2018**	**2017**
	In thousands	
Balance at beginning of period	$ 14	$ 30
Charges to costs and expenses	37	5
Account write-offs and other deductions	(2)	(21)
Balance at end of period	$ 49	$ 14

INVENTORY

The Company values inventories at the lower of cost or net realizable value 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.

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

CAPITALIZATION OF SOFTWARE DEVELOPMENT FOR SALE

The Company's capitalizes software development for sale in accordance with ASC 985-20. All costs associated with establishing technical feasibility are expensed. Once technical feasibility has been established, the costs of coding the software are capitalized and amortized over the expected life of the product. Once the product is release to production, all future software de-bug costs are expensed in the period.

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 and are assessed for impairment when triggering events occur. 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.

(LOSS) INCOME PER SHARE

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

As of December 31, 2018, 30,064,867 shares underlying options and 500,000 shares underlying warrants could potentially have been included in the calculation of diluted shares. However, as the exercise price at December 31, 2018 was $0.06 per share, only 8,105,000 exercisable options were included in the calculation of earnings per share. All other options and warrants exercise price exceeded the market price, or were unvested.

As of December 31, 2017, 29,860,040 shares underlying options and 1,406,067 shares underlying warrants could potentially have been included in the calculation of diluted shares. However, as the exercise price at December 31, 2017 was $0.10005 per share, only 11,128,457 exercisable options and 500,000 warrants were included in the calculation of earnings per share. All other options and warrants exercise price exceeded the market price, or were unvested.

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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.

Effective January 1, 2018, the Company has recognized revenue under FASB ASC 606, whereby all contracts containing a performance element have been evaluated for the necessity to recognize revenue as the performance obligation is achieved.

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,	
	2018	2017
	In thousands	
Balance at beginning of period	$ 184	$ 149
Charges to costs and expenses	9	114
Account write-offs and other deductions	(23)	(79)
Balance at end of period	$ 170	$ 184

ADVERTISING EXPENSE

The Company expenses advertising costs as incurred. Advertising expenses for the years ended 2018 and 2017 were $0.1 million and $0.1 million, respectively.

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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 initially 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, 2018 or 2017.

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.

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

During 2018, the Company recognized $1.1 million of stock-based compensation related to options and fully vested shares issued to the directors and employees as compensation (See Note 11), all of which were charged to selling, general and administrative expense. During 2017, the Company recognized $0.6 million of stock-based compensation related to options and fully vested shares issued to the directors and employees as compensation (See Note 11), all of which were 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.

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 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, 2018, the Company estimated the fair value of long term fixed rate debt to be $1.3 million compared to its carrying value of $1.0 million (2017: fair value of $0.1 million compared to its carrying value of $0.1 million).

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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 2018 and one customer accounting for 10% or more of consolidated revenues in 2017. The Company had no customer that accounted for 10% or more of the outstanding accounts receivable balance at December 31, 2018 or at December 31, 2017. The Company maintains its cash and cash equivalents in bank deposit accounts, which at times may exceed insured limits. At December 31, 2018, the amount in excess of governmental insurance protection was $1.7 million, measured across all entities and jurisdictions. At December 31, 2017, the amount in excess of governmental insurance protection was $1.9 million. The Company believes it is not exposed to any significant credit risk on cash and cash equivalents.

USE OF ESTIMATES

In preparing these consolidated financial statements in accordance with generally accepted accounting policies, management has made judgments, estimates, and assumptions that affect the reported amounts of assets, liabilities, income, and expenses. Actual results may differ from those estimates. Estimates and underlying assumptions are reviewed on an on-going basis. Revisions to estimates are recognized prospectively.

(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 guidance also includes enhanced disclosure requirements, and was effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2017. For all other entities, the ASU was effective for annual periods in fiscal years beginning after December 15, 2018, and interim periods in fiscal years beginning after December 15, 2019. 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 have adopted the new guidance effective January 1, 2018. Based on existing contracts at year end and as of now, the Company has not identified any contract that will have an impact on our financial statements. Based on the current estimated impact to our financial statements, we have adopted the new guidance under the modified retrospective approach.

(3) RECENT ACCOUNTING PRONOUNCEMENTS (continued)

Effective January 1, 2018, the Company has adopted ASC 606, Revenue from Contracts with Customers.

ASC 606 outlines principles for the measurement and recognition of revenue from contracts with customers, with the core principle being that revenue should be recognized at an amount that reflects the consideration to which an entity expects to be entitled in exchange for the transfer of goods and services to the customer. In order to achieve this objective, the standard sets out a five-step model:

1. Identify the contract(s) with a customer.
2. Identify the performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations.
5. Recognise revenue when or as the entity satisfies a performance obligation.

The standard also covers the accounting for the incremental costs of obtaining a contract and the costs to fulfil a contract, together with presentation and disclosure requirements.

The impact of applying ASC 606 to the Company's financial statements has been assessed by income stream and no changes in revenue recognition policies has been required.

All contracts at December 31, 2018 have standard warranty periods and there were no contracts in backlog that carried an enhanced performance criteria clause, which would require the entity to treat the revenue recognition differently than under ASC 606.

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. The new standard has been applied by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of 2018, with certain exceptions. The impact to the consolidated financial statements has been minimal.

Leases. In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)* in order to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet for those leases classified as operating leases under current GAAP. ASU 2016-02 requires that a lessee should recognize a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term on the balance sheet. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018 (including interim periods within those periods) using a modified retrospective approach and early adoption is permitted. The Company will adopt ASU 2016-02 in the first half of 2019 utilizing the modified retrospective transition method through a cumulative-effect adjustment at the beginning of the first half of 2019. While the Company is continuing to assess the potential impacts of ASU 2016-02, the Company estimates that the adoption of ASU 2016-02 will result in the recognition of right-of-use assets and lease liabilities for operating leases of $0.6 million on its Consolidated Balance Sheets, with no material impact to its Consolidated Statements of Operations.

(3) RECENT ACCOUNTING PRONOUNCEMENTS (continued)

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 was effective for us beginning in the first quarter of 2017. The adoption of this update had no significant impact on our consolidated financial statements.

Balance Sheet Classification of Deferred Taxes. In 2017 the Company elected to early adopt ASU 2015-17, Balance Sheet Classification of Deferred Taxes, which requires all deferred tax assets and liabilities, and related valuation allowances, to be classified as noncurrent. ASU 2015-17 was effective for the Company for annual periods in fiscal years beginning after December 15, 2017, and requires either prospective or retrospective adoption. The Company elected to early adopt the new standard for the current reporting period, which was permitted, and applied a prospective transition method.

In May 2017, the FASB issued and an accounting standards update to provide clarity and reduce (1) diversity in practice and (2) cost and complexity when applying the guidance in Topic 718, Compensation – Stock Compensation, to a change to the terms or conditions of a share-based payment award. An entity may change the terms or conditions of a share-based payment award for many different reasons, and the nature and effect of the change can vary significantly. Some entities evaluate whether a change to the terms or conditions of an award is substantive. When the conclusion is that it is substantive, then the entity must apply the modification accounting in Topic 718. However, if the conclusion is that it is not substantive, then the modification accounting in Topic 718 does not apply. This amendment was effective for all entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. Topic 718 had no impact of our consolidated financial statements.

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 do not believe there will be any impact from 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 do not believe there will be any impact from 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 net realizable value when applicable and include materials, labor and overhead. Inventories are as follows:

Years Ended December 31	2018	2017
	In thousands	
Finished goods	$ 602	$ 517
Work in-process	339	415
Raw materials	2,073	1,981
Gross inventories	$ 3,014	$ 2,913
Inventory reserves	(615)	(633)
Net inventories	$ 2,399	$ 2,280

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 net realizable value.

(5) PROPERTY, PLANT AND EQUIPMENT

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

Years Ended December 31	2018	2017
	In thousands	
Buildings and building improvements	$ 284	$ 288
Computer equipment	464	409
Machinery and equipment	2,220	2,219
Furniture and fixtures	488	484
Property, plant and equipment	$ 3,456	$ 3,400
Less accumulated depreciation	(2,810)	(2,767)
Net property, plant and equipment	$ 646	$ 633

Depreciation expense from operations was $0.2 million and $0.1 million in the years ended December 31, 2018 and 2017, 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 2018, and at the end of the fourth quarter 2017, the Company concluded that no impairment existed. The conclusion resulted from a combination of the project discounted cash flows under normal forecasted cash flow projections, as well as from discounted cash flows with a sensitivity analysis showing no growth in revenues.

The changes in the carrying amount of goodwill for the years ended December 31, 2018 and 2017 were as follows:

	December 31, 2018	December 31, 2017
	In thousands	
Beginning of the year	$ 424	$ 372
Effect of exchange rate	(19)	52
End of year	$ 405	$ 424

The Company operates in two reporting units: LED's (light emitting diode systems) and Laser & Diodes. Goodwill as of December 31, 2018 and 2017 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 2018. 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

(7) INTANGIBLE ASSETS (continued)

Gross carrying amounts and accumulated amortization of intangible assets were as follows as of December 31, 2018 for each intangible asset class. The gross carrying values and the accumulated amortization values are impacted by the foreign currency translation adjustment.

	Gross Carrying Amount	Accumulated Amortization	Net Balances
		In thousands	
Acquired customer contracts and relationships	1,595	(1,595)	-
Acquired technology design and programs	270	(270)	-
Other	88	(88)	-
Total	$ 1,953	$ (1,953)	$ -

Gross carrying amounts and accumulated amortization of intangible assets were as follows as of December 31, 2017 for each intangible asset class.

	Gross Carrying Amount	Accumulated Amortization	Net Balances
		In thousands	
Acquired customer contracts and relationships	1,690	(1,690)	-
Acquired technology design and programs	286	(286)	-
Other	93	(93)	-
Total	$ 2,069	$ (2,069)	$ -

(8) DEBT

Years Ended December 31		2018[(1)]	2017[(1)]
		In thousands	
Senior Fixed Rate Secured Term Note to SQN ("SQN Note"), maturing on June 13, 2022 with an interest rate of 10%, at December 31, 2018.	Total debt less unamortized debt issuance costs	$769	$-
Borrowings under Revolving Credit facility with Barclays Bank Sales Financing with an interest rate of 2.0% above Barclay's base rate at December 31, 2018 and at December 31, 2017 (2.25% as of December 31, 2018 and at December 31, 2017).	Principal Amount	$1,075	$1,293
Total All Debt	Principal Amount	$1,844	$1,293
	Less: Revolving Credit Facility	$(1,075)	$(1,293)
	Less: current portion of long term debt	$(188)	$(1,293)
	Long-term debt less unamortized discount and debt issuance costs	$581	$-

(1) As of December 31, 2018 and 2017, the Company had $0.2 million and $0.4 million, respectively available under the various borrowing facilities.

Scheduled future maturities of debt for the next five years:

Due by period	2019	2020	2021	2022	2023+	Total
				In thousands		
Debt obligations.....................	$ 1,075	$ -	$ -	$ 769	$ -	$ 1,844

BORROWING AGREEMENTS

Term Notes:

ProPhotonix (IRL) Limited Senior Fixed Rate Term Note

On June 14, 2018, ProPhotonix (IRL) Limited was issued a four-year 10% Senior Fixed Rate Term Note ("SQN Note"), from SQN Secured Income Fund PLC ("SQN") in the original principal amount of £0.7 million ($0.9 million at June 14, 2018) secured by certain assets of ProPhotonix (IRL) Limited.

At December 31, 2018, the company breached a calculated debt covenant ratio. Subsequent to year end the company has obtained a waiver from SQN stating the debt will not be called.

(8) DEBT (continued)

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.

The most recent amendment of February 10, 2016, included (i) increased the line from £1.4 million to £1.5 million; (ii) reduced service charges and the discount rate from 2.50% plus Barclays base rate to 2.00% plus Barclays base rate (iii) increased 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 which has been extended through January 21, 2020.

The amount outstanding under the facility was $1.1 million as of December 31, 2018 and $1.3 million as of December 31, 2017 reported as a short-term debt under revolving credit facility. As of December 31, 2018 and 2017, the Company had $0.2 million and $0.4 million respectively, available under this facility.

(9) TAXES

The Company is required to determine whether its tax positions are “more-likely-than-not” to be sustained upon examination by the applicable taxing authority, based on the technical merits of the position. Tax positions not deemed to meet a “more-likely-than-not” threshold would be recorded as a tax expense in the current year. Based on its analysis, the Company has determined that it has not incurred any liability for unrecognized tax benefits as of December 31, 2018. The Company had deferred tax assets, before considering the full valuation allowance, totaling $14.9 million as of December 31, 2018 and $14.3 million as of December 31, 2017. 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 Tax Cuts and Jobs Act, which contains significant changes to the U.S. income tax regime, was signed into law on December 22, 2017. While we have limited U.S. operations, certain aspects of the 2017 U.S. Tax Act could have a meaningful impact on our income tax expense. In addition to lowering the U.S. corporate tax rate from 35% to 21% effective January 1, 2018, the 2017 U.S. Tax Act contains significant changes to the U.S. income tax regime, including changes to the formation and use of net operating losses incurred after December 31, 2017, changes to the income tax deductibility of certain business expenses, including interest expense and compensation paid to certain executive officers, the imposition of taxes on a one-time deemed mandatory repatriation of earnings and profits of foreign corporations and a new tax on global intangible low-taxed income.

(9) TAXES (continued)

Based on the size of the Company's historical U.S. operating losses, there is doubt as to when, if ever, any of the deferred tax assets related to its U.S. operations 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. As it relates to a deferred tax impact relative to stock compensation, the Company believes the deferred tax asset being disclosed in the footnote table below reflects the book compensation previously recognized for grants outstanding as of the end of the year (fully or partially vested) times the appropriate tax rate. In 2018 and 2017, the Company has evaluated its deferred tax status of all of its operations, and has concluded that its Ireland entity should recognize a deferred tax asset in 2017 based on forward looking forecast operating profits in relation to its loss carryforwards of $0.5 million. 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 2018 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 2012 through 2018 are open to examination in foreign jurisdictions.

The following is a reconciliation of the federal income tax provision calculated at the statutory rate of 21% to the recorded amount:

	2018	2017
	In thousands	
Years Ended December 31,		
(Loss) income before taxes	$ (1,308)	$ 2,041
Reconciliation		
Applicable statutory federal income tax expense	(275)	429
Foreign tax rate differential	58	(116)
Non-deductible items	9	4
Valuation allowance	208	(786)
Net income tax provision	$ -	$ (469)

(9) TAXES (continued)

The significant items comprising the deferred tax asset and liability at December 31, 2018 and 2017 are as follows:

Years Ended December 31,

	2018	2017
	In thousands	
Domestic net operating loss carry forwards	$ 12,543	$ 12,885
Foreign net operating loss carry forwards	1,197	1,000
R&D tax credit	525	525
Other	690	593
Valuation allowance	(14,501)	(14,528)
Deferred tax asset	$ 454	$ 475

As of December 31, 2018, the Company had United States federal net operating loss carry forwards (NOLs) of $62.6 million (2017: $61.0 million) available to offset future taxable income, if any. These carry forwards expire through 2035 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 U.S. historical operating losses raise considerable doubt as to when, if ever, any of the deferred tax assets will be realized for U.S. operations, even though there have been limited operating profits in each of the last three years. As a result, management has provided a full valuation allowance for the net deferred tax assets.

At December 31, 2018, the Company also has Canadian federal NOLs of $1.1 million (2017: $1.1 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, 2018, the Company also has a United Kingdom NOL of $3.0 million (2017: $2.7 million). At December 31, 2018, the Company also has an Ireland NOL of $2.3 million (2017: $1.5 million), but has recorded a deferred tax asset of $0.5 million in 2017. The total valuation allowance against deferred tax assets increased by $0.5 million (2017: decreased by $0.3 million).

(10) UNREGISTERED SALES OF EQUITY SECURITIES AND WARRANTS OUTSTANDING

Warrants

On April 5, 2017, one of the Company's investors exercised a warrant for 1,900,000 shares at $0.03 per share for a total cash remittance of $0.1 million. There were no warrants exercised in 2018.

As of December 31, 2018, there were 500,000 common shares outstanding warrants with the following exercise prices and expiration dates:

Number of Common Shares Warrants	Exercise Price	Expiration Date
500,000	$0.10	2019

(11) STOCK OPTION PLANS

On June 9, 2014, the Company implemented its 2014 Stock Incentive Plan (the "2014 Plan"). On June 5, 2017, the Company amended the 2014 Stock Plan to increase the pool of shares available for issuance, and granted new performance-based options.

Remuneration policy for senior management

Summary
In order to incentivize the achievement of its objectives, the Company has implemented a 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 for senior management through the end of the three-year measurement period.
- Cliff vesting on December 31, 2019 at different levels dependent on achievement against the performance target (zero below 10% up to 150% vesting at 135% attainment)10-year option term.

- *Performance measure* - Performance plan has two vesting components; (i) an Annual vesting component that allows the participant to vest a maximum of 25% of the three year target at 100%, with a lessor amounts eligible to be vested where the annual growth rate is less than a 25% growth over the previous years' Adjusted EBITDA value (earnings before taxes, depreciation, interest, stock compensation and amortization). Each annual vest is earned outright by the individual regardless any prior or subsequent year's Adjusted EBITDA performance and (ii) the cumulative vesting component which is determined on the average total growth over the base Adjusted EBITDA (Base year = 2016) during the three years of 2017 to 2019. The cumulative vesting component allows the individual to vest shares based on the cumulative performance from 2017 to 2019. The maximum vesting under the combined scheme, at the end of three years, is the greater of (a) the sum of the shares vested annually or (b) vesting of shares based on the cumulative three year period.

(11) STOCK OPTION PLANS (continued)

Under the Company's 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, which was increased to 24,200,000 on June 5, 2017. In addition, from 2018 to 2025 there is an automatic 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.

As of December 31, 2018, there were 2,425,000 shares available to be issued from this plan.

On December 16, 2016, but effective January 1, 2017, the Board of Directors approved the Eighth Amended and Restated Policy Regarding Compensation of Independent Directors, (i) cash compensation is $30,000 per annum paid in arrears each quarter in installments of $7,500; and (ii) a grant of 75,000 fully vested shares of the Company's Common Stock, be automatically issued on the day after the annual meeting to each Independent Director who is serving as director of the Company immediately following the date of each annual meeting of stockholders (or special meeting in lieu thereof) beginning with the 2017 annual meeting. These shares are pursuant to the 2014 Plan terms and conditions. During the years ended December 31, 2018 and 2017 the Independent Directors each received $30,000 per annum of fees. On May 18, 2018 and May 19, 2017 each Independent Director received a grant of 75,000 fully vest shares of the Company's Common Stock with a total value of $49,000 and $47,000, respectively. Total director's compensation including other benefits are disclosed on pages 21 and 22 of this Annual Report.

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, 2018. There is an intrinsic value on the options outstanding, and exercisable, at December 31, 2018 of $0.2 million and $0.2 million, respectively. There was an intrinsic value on the options outstanding, and exercisable, at December 31, 2016 of $0.7 million and $0.6 million, respectively.

During 2018 and 2017, 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 1,000,000 options granted during the year ended December 31, 2018 and there were 12,870,000 options granted during the year ended December 31, 2017. These options vest over a one year, a three year, or a four-year anniversary of the grant date, provided that the recipient continues to serve the

(11) STOCK OPTION PLANS (continued)

company in that capacity until each such vesting, or achieves the performance objectives as noted above. The weighted average assumptions for grants during the years ended December 31, 2018 and December 31, 2017 used in the Black-Scholes option pricing model were as follows:

	Twelve months Ended December 31, 2018	Twelve months Ended December 31, 2017
Volatility…………………………………………..	207.74%	196.98%
Expected option life……………………………	7.8 years	7.8 years
Interest rate (risk free)………………………….	2.77%	1.45%
Dividends……………………………………….	$0	$0
Weighted average grant date fair value………..	$0.122	$0.239

	Options Outstanding	Weighted Average Exercise Price per Share ($)	Weighted Average Remaining Contractual Term (in Years)
Balance at December 31, 2016	23,690,040	0.07	6.15
Granted	12,870,000	0.24	
Exercised	(6,700,000)	0.04	
Cancelled	-	-	
Balance at December 31, 2017	29,860,040	0.15	6.74
Vested and Exercisable at December 31, 2017	16,473,790	0.08	4.64
Balance at December 31, 2017	29,488,132	0.15	6.68
Granted	1,000,000	0.12	
Exercised	(135,000)	0.03	
Cancelled	(660,173)	0.32	
Balance at December 31, 2018	30,064,867	0.14	5.92
Vested and Exercisable at December 31, 2018	16,712,367	0.07	3.88
Vested and Expected to Vest at December 31, 2018	20,495,157	0.10	4.75

Range of Exercise Prices	Options Outstanding	Weighted Average Contractual Life (years)	Weighted Average Exercise Price	Options Exercisable	Weighted Average Exercise Price
$ 0.02 – 0.24	30,064,867	5.9	$ 0.14	16,299,867	$ 0.07

(11) STOCK OPTION PLANS (continued)

At December 31, 2018, there was $1.0 million of total unrecognized compensation cost related to stock options granted (2017: $2.0 million). The cost is expected to be recognized over the next 1.51 years. Total stock option expense recorded in 2018 and 2017 was $1.1 million and $0.6 million, respectively. There were 135,000 options exercised in 2018 at an exercise price of $3,661, and having a market value of $18,900. There were 6,700,000 options exercised in 2017 at an exercise price of $238,260, and having a market value of $721,075.

(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, 2018 and 2017, there were no shares issued under the Stock Purchase Plan. On April 4, 2019 the Board of Directors ended this 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, 2018 and $26,000 in the year ended December 31, 2017. The Company incurred costs of $2,000 in 2018 and $2,000 in 2017 to administer the Plan. The Company also has voluntary contribution pension plans 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 $61,000 and $59,000 in the years ended December 31, 2018 and 2017. 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 $49,000 and $37,000 in the years ended December 31, 2018 and 2017, respectively. Plan administration costs come out of the plan itself.

(14) COMPANY FACILITIES, COMMITMENTS AND CONTINGENCIES

Other obligations and contingent liabilities

On February 24, 2017, the Company signed a 61-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. Previously, the Company leased approximately 3,600 square feet for its corporate headquarters and sales office in another Salem, New Hampshire location. The term of the lease required monthly tenant at-will payments with a 90 day termination notice. Base rent was $2,550 per month plus the tenant's share of expenses.

(14) COMPANY FACILITIES, COMMITMENTS AND CONTINGENCIES (continued)

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. The Company did not exercise this option during 2018. A £10,000 penalty applies if this six months' 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. At December 31, 2018, the outstanding balance of capital leases was $0.2 million and at December 31, 2017, the outstanding balance of capital leases was $0.2 million. 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, 2018 and December 31, 2017, is as follows:

	2018	2017
Assets under capital lease	$ 926,000	$ 883,000
Less—accumulated depreciation	(606,000)	(555,000)
Assets under capital lease, net	$ 320,000	$ 328,000

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

Due by Period	2019	2020	2021	2022	2023+	Total
	In thousands					
Capital lease obligations	69	69	27	12	4	181
Operating lease obligations	161	161	162	94	-	578
	$230	$230	$189	$106	$4	$759

The Company expensed $0.2 million and $0.2 million in rent for the years ended December 31, 2018 and 2017, 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 European Union (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 was up to €0.4 million and was completed in May 2018. During 2018, the Company billed the EU program for a total of $26,000 of direct expenses for reimbursement, as well as $6,000 of indirect expenses for a total of $32,000 . During 2017, the Company billed the EU program for a total of $0.2 million of direct expenses for reimbursement, as well as $0.1 million of indirect expenses for a total of $0.3 million. These amounts are reflected in the consolidated statements of income for the years ending December 31, 2018 and 2017. In addition, at years ending December 31, 2018 and 2017, the Company received advance funding with remaining totals zero and $0.3 million respectively, which are reflected on the consolidated balance sheets, net of any charges to the advances.

(17) DEFERRED REVENUE AND BACKLOG

At December 31, 2018, the Company had a total of $0.1 million in deferred revenue and $6.8 million in backlog. At December 31, 2017, the Company had a total of $0.1 million in deferred revenue and $7.3 million in backlog.

(18) 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.

(18) SEGMENT INFORMATION (continued)

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.

	2018	2017
	In thousands	
Years Ended December 31		
Revenues:		
LEDs	$ 7,953	$ 8,398
Laser & diodes	8,448	9,345
Total revenues	$ 16,401	$ 17,743
Gross profit:		
LEDs	$ 3,405	$ 4,199
Laser & diodes	2,939	3,722
Total gross profit	$ 6,344	$ 7,921
Operating (loss) profit:		
LEDs	$ (581)	$ 514
Laser & diodes	(413)	693
Total operating profit	$ (994)	$ 1,207

	2018	2017
	In thousands	
Years Ended December 31		
Current assets:		
LEDs	$ 2,316	$ 2,950
Laser & diodes	3,159	2,601
Corporate	2,024	2,228
Total current assets	$ 7,499	$ 7,779

(18) SEGMENT INFORMATION (continued)

	2018	2017
	In thousands	
Property, plant & equipment:		
LEDs	$ 293	$ 282
Laser & diodes	331	350
Corporate	22	1
Total property, plant & equipment	$ 646	$ 633
Goodwill:		
LEDs	$ 405	$ 424
Laser & diodes	—	—
Corporate	—	—
Total goodwill	$ 405	$ 424
Other assets:		
LEDs	$ 767	$ 635
Laser & diodes	103	74
Corporate	7	5
Total other assets	$ 877	$ 714
Total assets:		
LEDs	3,781	4,291
Laser & diodes	3,593	3,025
Corporate	2,053	2,234
Total assets	$ 9,427	$ 9,550

Years Ended December 31	2018	2017
	In thousands	
Revenues by geographic area:		
United States	$ 5,550	$ 5,580
Canada, Mexico & So. America	323	938
Europe	8,962	8,744
Asia & the rest of the world	1,566	2,481
Total	$ 16,401	$ 17,743

(18) SEGMENT INFORMATION (continued)

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

	2018	2017
	In thousands	
Years Ended December 31		
Long-lived assets by geographic area:		
United States and North America	$ 22	$ 1
Europe	698	706
UK	331	350
Total	$ 1,051	$ 1,057

(18) SUBSEQUENT EVENTS

The Company has evaluated subsequent events through March 29, 2019, the date which the financial statements were available to be issued. The Company has obtained a waiver from SQN, relating to a covenant ratio default under the loan (See Note 8), stating the term debt will not be called. On April 4, 2019 the Board of Directors dissolved the 2000 Employee Stock Purchase Plan (See Note 12) as no participation has occurred since the Stock Purchase Plan inception.

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