Annual Report 2020

ProPhotonix Partnership Approach

At ProPhotonix, our process always begins with the customer requirements. We recognize the importance of understanding every aspect of a customer's application and its impact on the illumination specification. Our engineering team will collaborate directly with a customer's engineers and project managers to ensure the correct design is developed. ProPhotonix then configures the optimum illumination from its established platforms or leverages the more than 350 combined years' experience of the multidisciplinary engineering experts to develop a product concept for your application. We work closely with our supply chain partners and manufacture many critical parts in-house to ensure reliable supply and a quick turnaround at each stage of the development process. ISO-certified production facilities ensure the Company operates to the highest quality standards. This is combined with the flexibility to produce a full range of illumination products from relatively simple laser collimators or LED arrays through to complex, powerful systems in both low and high volume for our customers across the globe.

Front Cover Images - From top to bottom

COBRA™ Clean FX1 - A UVC LED Light provides an ideal light source for evaluation of UVC applications such as water, surface and air disinfection in laboratory and medical, packaging materials, food processing, and industrial applications. This light source enables rapid development of a UVC LED solution. It can be configured with numerous optical and electrical options allowing system designers to define the most suitable configuration for their system.

PROdigii™ Digital Laser Module – This high-performance digital laser platform has been extended to offer five new wavelengths: 375nm, 405nm, 450nm, 905nm and 940nm. The extended range allows system designers and end users to benefit from high-performance lasers with superior control and monitoring in applications including UV curing and fluorescence detection, 3D printing, particle measurement, spectroscopy, robotics and gesture recognition as well as LiDAR applications.

COBRA™ MultiSpec – The COBRA MultiSpec platform has been extended to offer RGB-IR, RGB-White as well as hyperspectral options as standard options in addition to custom designs. The new options are ideally suited to specific market requirements and developed to provide optimal performance when paired with cameras based on the latest sensor technology. The growing range of multispectral and hyperspectral imaging applications in food sorting, grading and analysis, chemical and pharmaceutical analysis, and print inspection applications will benefit from these new additions.

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BUSINESS ACTIVITIES:

ProPhotonix and its subsidiaries ("ProPhotonix" and "Company") consists of two business units: a laser modules production and laser diode distribution business located in the United Kingdom (Hatfield Broad Oak), and an LED systems manufacturing business based in Ireland (Cork). 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 (machine vision illumination and UV curing), health care, 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. Ultraviolet ("UV") curing is an emerging market for both LED and laser technology. The primary market is curing of material (inks, adhesives, coatings) but also luminescence in biomedical and fluorescing applications.

Health Care

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, and a portable x-ray equipment and dental imaging manufacturer. The Company views the medical field a strategic market 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 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.

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2020 ANNUAL REPORT TO SHAREHOLDERS

To the Shareholders of ProPhotonix Limited:

Our business was not untouched by the outbreak of the COVID-19 pandemic in 2020 with our manufacturing plants in U.K. and Ireland closed for several weeks during the year, our customers' operations slowed as well and our revenue declined. As the breadth of the pandemic became apparent, we took a series of measures to mitigate the downside effect on our business. We cut back on operating costs through temporary pay reductions and, in some cases, elimination of certain personnel. We participated in government job retention schemes and took advantage of other government support measures and we deferred lease and loan payments where possible. These efforts led to generating cash from operating activities and put us in a position to make further investments in the business so that we may achieve our objectives.

We operate a subsidiary in the United Kingdom (UK) with implications relating to Brexit. In December 2020, the UK and the European Union entered into a trade and cooperation agreement. The agreement settles the uncertainty of trading between the two geographies though still leaves considerable uncertainty regarding the logistics and ease of movement of goods. During the period of transition, January 1, 2020 to December 31, 2020, and early in the first quarter of 2021 we have not experienced any substantive operational issues relating to Brexit.

Financial Summary:

Revenue decreased by $1.4 million, or 9%, for the year ended December 31, 2020 compared to the same period in 2019 and operating income decreased by $0.5 million over the same two periods. The decline in revenue was offset by significant reductions in operating costs and the benefit of $0.5 million of local government COVID-19 related support. Operating income for the year ended December 31, 2019 includes a benefit of stock option compensation of $1.2 million whereas operating income for the year ended December 31, 2020 includes a charge of stock option compensation of $58,000.

We generated $2.1 million of cash from our operating activities for the year ended December 31, 2020; repaid net debt of $0.9 million; and increased the cash position by $1.1 million compared to December 31, 2019. The net cash position (cash minus term debt and capital leases) was positive $1.9 million at December 31, 2020 compared to negative $0.1 million at December 31 2019.

Strategy:

The first part of our strategy relates to getting our operations back up to the point where we can meet what we expect to be more buying demand from our customers in 2021 and beyond. Our customer relationships are vitally important and we provide solutions to them to achieve their own 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 our strategy remains established in our OEM heritage as well as the development of products directed at specific markets. We have 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.

2020 Product Development:

During 2020, the Company developed and announced new products including: several variants of the MultiSpec product family addressing the multispectral and hyperspectral industrial markets; a deep UV (UVC, 265 nanometer) FX product targeted to the biomedical market; several variants of the PROdigii laser product family (from UV to Near Infrared wavelengths) addressing the industrial markets. Additionally, numerous OEM specific projects have been undertaken to address specific applications and use cases for existing and new customers. Product development, accomplished by the experts at ProPhotonix, is focused on applications in growing markets and OEM projects requiring unique attributes that are not attainable in the general market. Specific use cases include applications such as: Algae growth, eye health, railway inspection, and 3D printing.

Conclusion:

Overall, we are pleased with the year 2020. Though our revenue declined by 9%, largely from COVID-19, we were able to mitigate the reduction with an outstanding result. Most importantly, cash ended the year at $2.6 million, representing an increase of $1.1 million. The balance sheet strengthened not only from the increase in cash but also from a significant reduction in debt of $0.9 million. A measure of this improvement is the current ratio which improved to 2.0 from 1.7. We look forward to the opportunity that the future holds as we come through the pandemic to more prosperous times.

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, 2020

The Directors present their report for ProPhotonix and its subsidiaries (the "Company") together with the financial statements for the year December 31, 2020. The financial statements are prepared under United States Generally Accepted Accounting Principles ("US 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 ("US 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 US GAAP have been followed, subject to any material departures disclosed and explained in the Company's financial statements;
- assess the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern; and
- use the going concern basis of accounting unless they either intend to liquidate the Company or to cease operations, or, have no realistic alternative but to do so.

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. They are responsible for such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error, and have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Company and to prevent and detect 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 2020 was $244 thousand of which $50 thousand was not related to audit fees.

CORPORATE GOVERNANCE REPORT FOR THE YEAR ENDED DECEMBER 31, 2020

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. The Directors have adopted 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 principal means of communicating the Company's application of the QCA Code are the Company's most recent Annual Report (pages 7 – 18) and the Corporate Governance section on the Company's website (www.prophotonix.com).

This report sets out the Company's application of the Code, by the Board, and where appropriate, cross references other sections of the Annual Report. Where the Company's practices depart from the expectations of the Code, the Board has given an explanation as to why.

This statement has been collectively prepared by the Board of Directors of the Company (the "Board"). The Board refers to the QCA Corporate Governance Code as a useful guide to assist in articulating how the Company approaches and applies good corporate governance.

The QCA Code is constructed around ten broad principles and a set of disclosures which notes appropriate arrangements for growing companies and requires companies who have adopted the QCA Code to provide an explanation about how they are meeting those principles through the prescribed disclosures. In the table below, the Board explains how it has applied them.

1. **A strategy and business model which promotes long-term value creation for shareholders.**
   Business Activities (page 2)
   Letter to Shareholders (page 4)

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 8)

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 9-11)

5. **A well-functioning and balanced Board.**
   Board Overview (pages 12-14)
   Board of Directors (page 13)

6. **Board experience, skills and capabilities.**
   Board Overview (pages 12-14)
   Board of Directors (page 13)

7. **Performance of the Board and continuous improvement.**
   Board Overview (pages 12-14)

8. **Corporate culture based on ethical values and behaviors.**
   Corporate Culture and Social Responsibility (page 8)

9. **Effective governance structures which support good decision making.**
   Chairman's Introduction and Summary – Corporate Governance Report (page 7)
   Board Overview (pages 12-14)
   Board Committees (page 14)

10. **Communication of Company governance and performance.**
    Chairman's Introduction and Summary (page 7)
    Audit Committee Report (page 15)
    Governance, Nominations and Remunerations Committee Report (page 16-18)

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 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.

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 its principal risks and uncertainties as discussed in the Company's Admission Document which remains relevant. 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 one customer represented approximately 12% of total revenue in 2020. While customer concentration will change during any financial period, the loss of any of the key client, or the disruption in business of any 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. A decline in business of any of the Company's key 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.

PRINCIPAL RISKS AND UNCERTAINTIES (cont.)

RISK AREA	RISK/MITIGATION
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 operated with thin profit margins. The Company mitigates this risk by having access to capital via its relationship with KKV Investment Management Ltd., a lender to the Company, as well as 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.
	Cash Flow. Risk of the loss of revenue/cash flow relating to the COVID-19 virus outbreak. Cessation of a major customer operations could have a material negative impact to the Company. The Company is dependent upon sustained operations and shipments to generate revenue and cash flow. In the event of a government or self-imposed shutdown causing the cessation of shipments for a period, a shortfall of cash flow could occur. The Company accesses capital as mentioned above to mitigate this risk but there can be no assurance there will be sufficient capital to sustain a period of no shipments/revenue/cashflow.
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.
	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.

RISK AREA	**RISK/MITIGATION**
Operational (Cont.)	**Brexit.** One of the two operating subsidiaries operates in the United Kingdom (UK). In December 2020, the UK and the European Union entered into a trade and cooperation agreement. The agreement settles the uncertainty relating to trading between the two geographies though still leaves considerable uncertainty regarding the logistics and ease of movement of goods. During the period of transition, January 1 – December 31, 2020, and early in the first quarter of 2021 the Company has not experienced any substantive operational issues relating to Brexit.
	Supply Chain. Risks in the supply chain became evident and emphasized by the world-wide COVID-19 virus outbreak. Supply chain disruption due to COVID -19 including seemingly minor components, could have a material impact on the short-term aspects of the business. Such a scenario highlights the dependence on certain geographies for various supply chain requirements. Attempts are made to mitigate this risk by qualifying dual sourcing for critical components and assemblies. However, there can be no assurance that circumstances will not occur where supply chain disruptions negatively impact the business.
	Business Systems. The operations of the Company utilize multiple manufacturing and financial systems to routinely operate the business. These systems are beyond their supported life by the system designers. The risk to the Company is that one or more of these systems may cease to function or may operate ineffectively in the future. The Company mitigates this risk using third-party support services knowledgeable with the operating systems. There can be no assurance that continued service and support by third parties will be available in the future.

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, 2020 the Board met on 14 occasions. The Board usually has two meetings a year with extended time allowed where the focus is predominantly on core strategic issues. Board members are expected to devote sufficient time to the Company to enhance the overall strategy and objectives of the business. This commitment varies each year depending upon the circumstances. In the past two years, the Board has met an average of 16 times during the year.

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.

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 page 13. The Board of ProPhotonix is currently comprised of three Directors: the Non-Executive Chairman, a further Non-Executive Director and the Chief Executive Officer. As per the individual biographies, the Directors have a range of experience and provide a balance of skills, experience and knowledge to the Board. Members are expected to remain relevant in the skills they provide to the Company. In addition, the Company periodically seeks to keep the Members informed of relevant current-day matters from outside specialists such as solicitors and accountants.

BOARD OVERVIEW (cont.)

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 both Non-Executive Directors to be independent in terms of their ability to make unencumbered decisions for the long-term success of the Company. The Director biographies as at December 31, 2020 are below:

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.

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. Mr. Thompson was a Non-Executive Director of SANDAIRE Limited, a financial services company, from June 2018 until December 2020, at which time the company was sold. He was chairman of the Audit committee and a member of the Governance, Nominations and Remuneration committee during that time.

BOARD OVERVIEW (cont.)

A summary of Board and Committee meetings attended in the year ended December 31, 2020 is set out below:

	Meetings	**Current Member Attendance**
Board	14	98%
Audit Committee	5	100%
Governance, Nomination, Remuneration Committee	3	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, 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 the Chief Financial Officer. 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, 2020 the Audit Committee met on five occasions, and four meetings were attended by the external Auditor (KPMG LLP).

GOVERNANCE, NOMINATIONS AND REMUNERATION COMMITTEE

The Governance, Nominations and Remuneration Committee comprises only independent Non-Executive Directors and is supported by the Chief Executive Officer. 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.

SENIOR MANAGEMENT AND COMPANY FUNCTIONS

ProPhotonix's 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 QCA Code and consists of Messrs. Raymond J. Oglethorpe and Vincent Thompson, each of whom have been determined by the Board of Directors to be an "independent director", 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 QCA 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, 2020, 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 Committee considered, in conjunction with management and the external auditor, the significant areas of estimation, judgement and possible error in preparing the financial statements and disclosures, discussed how these were addressed and approved the conclusions of this work. The principal area of focus in this regard was in relation to going concern including the appropriateness of preparing the financial statements on a going concern basis and the appropriateness of the disclosures in the financial statements in relation to the risks associated with going concern assumption. 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. Based on information obtained from the independent accounting firm at mid-year and year end work performed and review with management, the Audit Committee concludes that the internal controls and control framework operate properly within 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. Each year the Company assesses the auditor activities and if appropriate will retender as deemed appropriate. 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, and approve if appropriate, all related party transactions on an ongoing basis. 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.

ProPhotonix's external Auditor is KPMG LLP, which has served the Company since September 2012 through a tender process. 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. Non-audit services are assessed for auditor independence by the Audit Committee and directed to other service providers as appropriate.

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

GOVERNANCE, NOMINATIONS AND REMUNERATIONS COMMITTEE REPORT

The GNR Committee consists of Messrs. Raymond J. Oglethorpe and Vincent Thompson each of whom have been determined by the Board of Directors to be an “independent director”, and to otherwise meet the nominating and compensation committee membership requirements promulgated by the SEC and 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 three times during the fiscal year ended December 31, 2020.

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 10 to the consolidated financial statements on page 48 of this annual report. 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, 2020 and 2019 (audited):

Executive Director	Salary	Pension	Other (1)	Total Cash Compensation	Options	Total Compensation - 2020
Tim Losik	$ 280,090	$ 6,500		$ 286,590	$ -	$ 286,590
Total Executive Director Compensation (2)	**$ 280,090**	**$ 6,500**	**$ -**	**$ 286,590**	**$ -**	**$ 286,590**
Non-Executive Director						
Ray Oglethorpe	$ -	$ -	$ 27,000	$ 27,000	$ -	$ 27,000
Vincent Thompson	-	-	27,000	27,000	-	27,000
Total Non-Executive Compensation	**$ -**	**$ -**	**$ 54,000**	**$ 54,000**	**$ -**	**$ 54,000**

Director Share Options:

Director	Options @ 12/31/19	Options Granted	Options Forfeited	Options Exercised	Options @ 12/31/20
Tim Losik	1,200,000	-	200,000	-	1,000,000
Ray Oglethorpe	1,949,586	-	382,920	-	1,566,666
Vincent Thompson	1,595,433	-	-	-	1,595,433
Total All Directors	**4,745,019**	**-**	**582,920**	**-**	**4,162,099**

(1) Other compensation for non-executive directors represents cash payments in the current year plus the value of fully vested shares issued in November 2020. See footnote 10 to the Financial Statements for a description of non-executive director compensation.

(2) Executive director compensation is reviewed by the non-executive directors.

Executive Director	Salary	Pension	Other (1)	Total Cash Compensation	Options	Total Compensation - 2019
Tim Losik	$ 325,750	$ 6,250		$ 332,000	$ -	$ 332,000
Total Executive Director Compensation (2)	**$ 325,750**	**$ 6,250**	**$ -**	**$ 332,000**	**$ -**	**$ 332,000**
Non-Executive Director						
Ray Oglethorpe	$ -	$ -	$ 33,600	$ 33,600	$ -	$ 33,600
Vincent Thompson	-	-	$ 33,600	33,600	-	33,600
Mark Weidman (3)	-	-	12,500	12,500	-	12,500
Timothy Steel (3)	-	-	12,500	12,500	-	12,500
Total Non-Executive Compensation	**$ -**	**$ -**	**$ 92,200**	**$ 92,200**	**$ -**	**$ 92,200**

Director Share Options:

Director	Options @ 12/31/18	Options Granted	Options Forfeited	Options Exercised	Options @ 12/31/19
Tim Losik	6,550,000	-	5,350,000	-	1,200,000
Ray Oglethorpe	2,029,296	-	79,710	-	1,949,586
Vincent Thompson	1,595,433	-	-	-	1,595,433
Total All Directors	**10,174,729**	**-**	**5,429,710**	**-**	**4,745,019**

(1) Other compensation for non-executive directors represents cash payments in the current year plus the value of fully vested shares issued in May 2019. See footnote 10 to the Financial Statements for a description of non-executive director compensation.

(2) Executive director compensation is reviewed by the non-executive directors.

(3) Served as directors until May 2019. Option information shown only for active directors at December 31, 2019.

ProPhotonix Limited

Consolidated Financial Statements

Years Ended December 31, 2020 and 2019

CONSOLIDATED FINANCIAL STATEMENTS

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

Independent auditor's report

to the directors of ProPhotonix Limited

1. Our opinion is unmodified

We have audited the consolidated financial statements of ProPhotonix Limited ("the Group") for the year ended 31 December 2020 which comprise the consolidated balance sheets, the consolidated statements of operations and comprehensive income, the consolidated statements of stockholders' equity and the consolidated statements of cash flows and the related notes, including the accounting policies in note 1 and 2.

In our opinion the consolidated Financial statements:

- give a true and fair view of the state of the Group's affairs as at 31 December 2020 and of the Group's profit for the year then ended;
- have been properly prepared in accordance with U.S. generally accepted accounting principles (GAAP).

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) ("ISAs (UK)") and applicable law. Our responsibilities are described below. We have fulfilled our ethical responsibilities under, and are independent of the Group in accordance with, UK ethical requirements including the FRC Ethical Standard as applied to listed entities. We believe that the audit evidence we have obtained is a sufficient and appropriate basis for our opinion.

Overview		
Materiality: Group financial statements as a whole		$75,000 (2019:$74,800) 0.5% of Total average revenue for the last 3 years (2019 0.5% of Total revenue)
Coverage		100% (2019:100%) of Group revenue
Key audit matters		**vs 2019**
Recurring risks	Going concern	◄►

2. Key audit matters: our assessment of risks of material misstatement

Key audit matters are those matters that, in our professional judgement, were of most significance in the audit of the financial statements and include the most significant assessed risks of material misstatement (whether or not due to fraud) identified by us, including those which had the greatest effect on the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. In arriving at our audit opinion above, the key audit matters, in decreasing order of audit significance, were as follows:

	The risk	Our response
Going concern Refer to page 31 (Organization and basis of presentation)	**Disclosure quality:** The financial statements explain how the Board has formed a judgement that it is appropriate to adopt the going concern basis of preparation for the Group. That judgement is based on an evaluation of the inherent risks to the Group's business model and how those risks might affect the Group's financial resources or ability to continue operations over the period to 31 December 2022. The risks most likely to adversely affect the Group's available financial resources over this period were the ability to generate and sustain revenue and the underlying cash flows from existing customers necessary to maintain and run the business as a result of the Covid-19 impact and the subsequent effect on customer confidence, such as existing customers delaying or cancelling orders. The risk for our audit was whether or not those risks were such that they amounted to a material uncertainty that may have cast significant doubt about the ability to continue as a going concern. Had they been such, then that fact would have been required to have been disclosed.	We considered whether these risks could plausibly affect the liquidity and covenant compliance in the going concern period by assessing the directors' sensitivities over the level of available financial resources and covenant thresholds indicated by the Group's financial forecasts taking account of severe, but plausible, adverse effects that could arise from these risks individually and collectively. We performed the tests below rather than seeking to rely on any of the Group's controls because the nature of the risk is such that we would expect to obtain audit evidence primarily through the detailed procedures described. Our procedures also included: — **Historical comparisons:** We assessed the historical accuracy of the directors' past forecasts by comparing those past forecasts to actual results. — **Benchmarking assumptions:** We challenged and critically assessed the forecasts prepared by the directors by benchmarking the key assumptions to external data, where available, and assessing whether those assumptions are consistent with our knowledge of the business gained during our audit and the current economic environment; — **Funding assessment:** We obtained direct confirmation from the lender of the Group's debt facilities balance as at 31 December 2020; — **Sensitivity analysis:** We considered sensitivities over the level of available financial resources indicated by the Group's financial forecasts taking account of reasonably possible (but not unrealistic) adverse effects that could arise from these risks individually and collectively;

The risk	Our response (continued
Going concern (continued) Refer to page 31 (Organization and basis of presentation)	— **Evaluating Directors' intent**: We evaluated the achievability of the actions the Directors consider they would take to improve the position should the risks materialise. This was done by critically assessing the mitigating actions available to the directors in the context of the business, assessing whether they are wholly within the directors' control and assessing the ability of the directors to implement the mitigating actions within the timeframe needed. — **Assessing transparency:** We assessed the completeness and accuracy of the matters covered in the going concern disclosure by comparing it to our knowledge obtained during the audit.

In the prior year we reported a key audit matter in respect of the impact of uncertainties due to the UK exiting the European Union. Following the trade agreement between the UK and the EU, and the end of the EU-exit implementation period, the nature of these uncertainties has changed. We continue to perform procedures over material assumptions in forward looking assessments such as going concern however we no longer consider the effect of the UK's departure from the EU to be a separate key audit matter.

3. Our application of materiality and an overview of the scope of our audit

Materiality for the Group financial statements as a whole was set at $75,000 (2019 : $74,800), determined with reference to a benchmark of revenue, normalised by averaging over the last three years of $14.982m of which it represents 0.5% (2019: 0.5% of total revenue for the year). We consider total average revenue over the last 3 years to be the most appropriate benchmark given the impact of Covid-19 on the results for 2020 and an average of 3 years being more representative of normal operations. A revenue benchmark is used as it provides a more stable measure year on year than Group profit before tax.

In line with our audit methodology, our procedures on individual account balances and disclosures were performed to a lower threshold, performance materiality, so as to reduce to an acceptable level the risk that individually immaterial misstatements in individual account balances add up to a material amount across the financial statements as a whole.

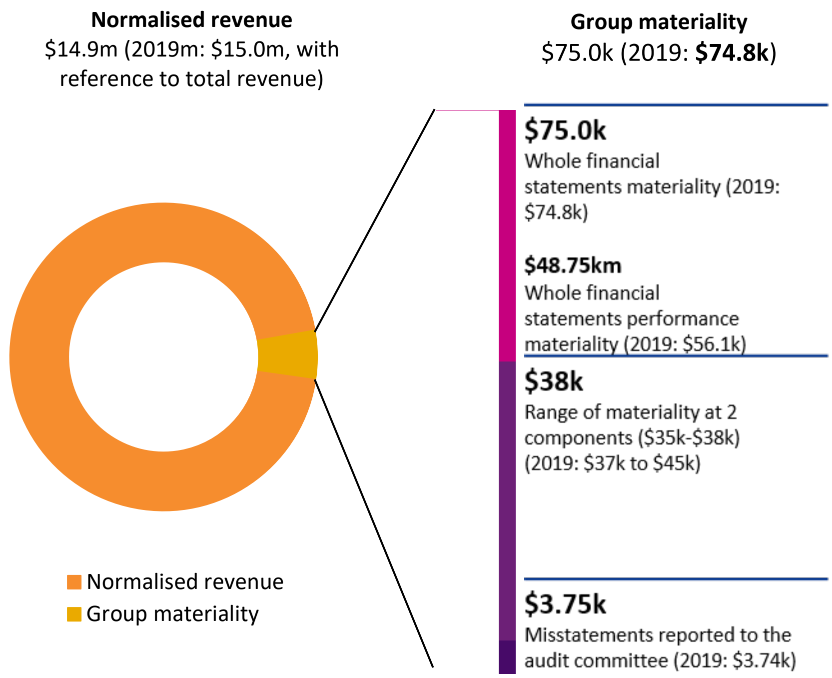
Performance materiality was set at 65% (2019: 75%) of materiality for the financial statements as a whole, which equates to $48,750 (2019: $56,100) for the Group. We applied this percentage in our determination of performance materiality based on the level of identified misstatements and control deficiencies during the prior period.

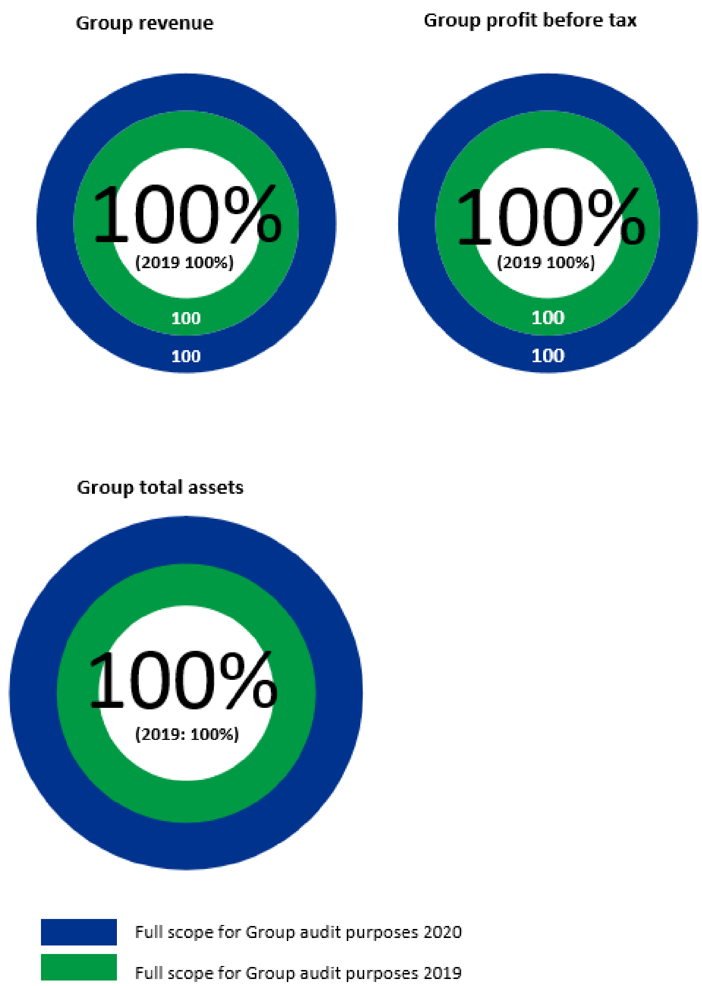
We agreed to report to the Audit Committee any corrected or uncorrected identified misstatements exceeding $3,750 (2019: $3,740), in addition to other identified misstatements that warranted reporting on qualitative grounds.

Of the Group's 2 (2019: 2) reporting components, we subjected 2 (2019: 2) to full scope audits for Group purposes.

The components within the scope of our work accounted for the percentages illustrated opposite.

The component materialities, ranged from $35,000 to $38,000 (2019: $37,000 to $45,000), having regard to the mix of size and risk profile of the Group across the components. The work on all of the components (2019: all of the components) was performed by Group team.





4. Going concern

The Directors have prepared the financial statements on the going concern basis as they do not intend to liquidate the Group or to cease their operations, and as they have concluded that the Group's financial position means that this is realistic. They have also concluded that there are no material uncertainties that could have cast significant doubt over their ability to continue as a going concern for at least a year from the date of approval of the financial statements ("the going concern period").

An explanation of how we evaluated management's assessment of going concern is set out in the related key audit matter in section 2 of this report.

Our conclusions based on this work:

— we consider that the directors' use of the going concern basis of accounting in the preparation of the financial statements is appropriate;

— we have not identified, and concur with the directors' assessment that there is not, a material uncertainty related to events or conditions that, individually or collectively, may cast significant doubt on the Group's ability to continue as a going concern for the going concern period; and

— we found the going concern disclosure in note 1 to be acceptable.

However, as we cannot predict all future events or conditions and as subsequent events may result in outcomes that are inconsistent with judgements that were reasonable at the time they were made, the above conclusions are not a guarantee that the Group will continue in operation.

5. Fraud and breaches of laws and regulations – ability to detect

Identifying and responding to risks of material misstatement due to fraud

To identify risks of material misstatement due to fraud ("fraud risks") we assessed events or conditions that could indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud. Our risk assessment procedures included

- Enquiring of directors and inspection of policy documentation as to the Group's high-level policies and procedures to prevent and detect fraud as well as whether they have knowledge of any actual, suspected or alleged fraud;
- Reading Board meeting minutes;
- Considering remuneration incentive schemes and performance targets for management and directors under the Stock Incentive Plan and the Directors Remuneration policy;
- Using analytical procedures to identify any unusual or unexpected relationships.

We communicated identified fraud risks throughout the audit team and remained alert to any indications of fraud throughout the audit.

As required by auditing standards, and taking into account possible pressures to meet profit targets and our overall knowledge of the control environment, we perform procedures to address the risk of management override of controls and the risk of fraudulent revenue recognition, in particular the risk that revenue is recorded in the wrong period and the risk that Group and component management may be in a position to make inappropriate accounting entries.

We did not identify any additional fraud risks.

We also performed the following procedure:

• Identifying journal entries and other adjustments to test for all full scope components based on risk criteria and comparing the identified entries to supporting documentation. These included those posted to unusual accounts and cash postings outside the normal course of business .

Identifying and responding to risks of material misstatement due to non-compliance with laws and regulations

We identified areas of laws and regulations that could reasonably be expected to have a material effect on the financial statements from our general commercial and sector experience, and through discussion with the directors and other management (as required by auditing standards), and discussed with the directors and other management the policies and procedures regarding compliance with laws and regulations.

We communicated identified laws and regulations throughout our team and remained alert to any indications of non-compliance throughout the audit.

The potential effect of these laws and regulations on the financial statements varies considerably.

Firstly, the Group is subject to laws and regulations that directly affect the financial statements including financial reporting legislation and taxation legislation and we assessed the extent of compliance with these laws and regulations as part of our procedures on the related financial statement items.

Secondly, the Group is subject to many other laws and regulations where the consequences of non-compliance could have a material effect on amounts or disclosures in the financial statements, for instance through the imposition of fines or litigation. We identified the following areas as those most likely to have such an effect: health and safety, anti-bribery and employment law. Auditing standards limit the required audit procedures to identify non-compliance with these laws and regulations to enquiry of the directors and other management and inspection of regulatory and legal correspondence, if any. Therefore, if a breach of operational regulations is not disclosed to us or evident from relevant correspondence, an audit will not detect that breach.

Context of the ability of the audit to detect fraud or breaches of law or regulation

Owing to the inherent limitations of an audit, there is an unavoidable risk that we may not have detected some material misstatements in the financial statements, even though we have properly planned and performed our audit in accordance with auditing standards. For example, the further removed non-compliance with laws and regulations is from the events and transactions reflected in the financial statements, the less likely the inherently limited procedures required by auditing standards would identify it.

In addition, as with any audit, there remained a higher risk of non-detection of fraud, as these may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal controls. Our audit procedures are designed to detect material misstatement. We are not responsible for preventing non-compliance or fraud and cannot be expected to detect non-compliance with all laws and regulations.

6. We have nothing to report on the other information in the Annual Report

The directors are responsible for the other information presented in the Annual Report together with the financial statements. Our opinion on the financial statements does not cover the other information and, accordingly, we do not express an audit opinion or, except as explicitly stated below, any form of assurance conclusion thereon.

Our responsibility is to read the other information and, in doing so, consider whether, based on our financial statements audit work, the information therein is materially misstated or inconsistent with the financial statements or our audit knowledge. Based solely on that work we have not identified material misstatements in the other information.

7. Respective responsibilities

Directors' responsibilities

As explained more fully in their statement set out on page 6, the directors are responsible for: the preparation of the financial statements including being satisfied that they give a true and fair view; such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; assessing the Group's ability to continue as a going concern, disclosing, as applicable, matters related to going concern; and using the going concern basis of accounting unless they either intend to liquidate the Group or to cease operations, or have no realistic alternative but to do so.

Auditor's responsibilities

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue our opinion in an auditor's report. Reasonable assurance is a high level of assurance, but does not guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

A fuller description of our responsibilities is provided on the FRC's website at www.frc.org.uk/auditorsresponsibilities.

8. The purpose of our audit work and to whom we owe our responsibilities

Our report has been prepared for the Group solely in accordance with the terms of our engagement and in connection with the requirements of Rule 19 of the AIM Rules for Companies.

Our audit work has been undertaken so that we might state to the Group those matters we are required to state to them in an auditor's report and for no other purpose. Our report should not be regarded as suitable to be used or relied on by any party wishing to acquire rights against us other than the Group for any purpose or in any context. Any party other than the Group who obtains access to our report or a copy and chooses to rely on our report (or any part of it) will do so at its own risk. To the fullest extent permitted by law, KPMG LLP will accept no responsibility or liability in respect of our report to any other party.

KPMG LLP

KPMG LLP

Chartered Accountants The Pinnacle

170 Midsummer Boulevard Milton Keynes MK9 1DF

24 March 2021

PROPHOTONIX LIMITED AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

(In thousands except share data)

December 31	**2020**	**2019**
Assets		
Current assets:		
Cash and cash equivalents	$ 2,641	$ 1,477
Accounts receivable, less allowances of $9 in 2020 and $10 in 2019 (Note 2)	2,216	2,801
Inventories, less allowances of $873 in 2020 and $782 in 2019 (Note 3)	2,651	2,584
Prepaid expenses and other current assets	484	678
Total current assets	7,992	7,540
Net property, plant and equipment (Note 4)	512	573
Operating lease right-of-use asset (Note 13)	190	312
Goodwill (Note 5)	432	397
Intangible assets, net (Note 6)	458	377
Other long-term assets	129	166
Total assets	$ 9,713	$ 9,365
Liabilities and Stockholders' Equity		
Current liabilities:		
Revolving credit facility (Note 7)	$ —	$ 912
Current portion of long-term debt (Note 7)	329	220
Accounts payable	1,460	1,941
Accrued payroll, benefits and incentive compensation	419	283
Deferred revenue (Note 15)	553	553
Accrued warranty expenses (Note 2)	168	164
Other accrued expenses	562	276
Operating lease liabilities, current (Note 13)	117	119
Current portion of finance lease obligations (Note 13)	43	58
Total current liabilities	3,651	4,526
Deferred revenue, noncurrent (Note 15)	409	227
Operating lease liabilities, noncurrent (Note 13)	73	193
Long term debt obligations, net of current portion (Note 7)	346	387
Long term finance lease obligations, net of current portion (Note 13)	23	40
Total liabilities	4,502	5,373
Stockholders' Equity:		
Common stock, par value $0.001; shares authorized 250,000,000 at December 31, 2020 and 2019; 93,300,402 shares issued and outstanding at December 31, 2020 and 93,150,402 shares issued and outstanding at December 31, 2019	93	93
Additional paid-in capital	112,894	112,838
Deferred compensation	—	(2)
Accumulated deficit	(108,658)	(109,750)
Accumulated other comprehensive income	882	813
Total stockholders' equity	5,211	3,992
Total liabilities and stockholders' equity	$ 9,713	$ 9,365

See the notes to consolidated financial statements.

PROPHOTONIX LIMITED AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME
(In thousands except share and per share data)

Years Ended December 31,	**2020**	**2019**
Revenue	$ 13,558	$ 14,976
Cost of revenue	(7,862)	(8,969)
Gross profit	5,696	6,007
Research & development expenses	(980)	(1,226)
Selling, general & administrative expenses	(4,126)	(3,686)
Operating income	590	1,095
Other income, net	1	53
Foreign currency exchange gains	161	25
Warrant & debt acquisition expense	(10)	(14)
Interest expense	(71)	(106)
Income before taxes	671	1,053
Income tax benefit/(expense)	421	(57)
Net income	$ 1,092	$ 996
Other comprehensive income:		
Foreign currency translation	69	(69)
Total comprehensive income	$ 1,161	$ 927
Net income per share: basic and diluted:		
Basic net income per share	$0.012	$0.011
Diluted net income per share	$0.011	$0.011
Shares used in per share calculations - basic	93,225,402	93,150,402
Shares used in per share calculations - diluted	101,480,402	93,150,402

See the notes to consolidated financial statements.

PROPHOTONIX LIMITED AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(In thousands)

	Shares	Par $0.001	Paid in Capital	Deferred Compensation	Accumulated Deficit	Accumulated Other Comprehensive Income	Total Stockholders' Equity
Balance December 31, 2018	93,000	$ 93	$ 114,067	$ (19)	$ (110,746)	$ 882	$ 4,277
Net income	—	—	—	—	996	—	996
Translation adjustment	—	—	—	—	—	(69)	(69)
Deferred compensation	150	—	(17)	17	—	—	—
Share based compensation	—	—	(1,212)	—	—	—	(1,212)
Balance December 31, 2019	93,150	93	112,838	(2)	(109,750)	813	3,992
Net income	—	—	—	—	1,092	—	1,092
Translation adjustment	—	—	—	—	—	69	69
Deferred compensation	150	—	(2)	2	—	—	—
Share based compensation	—	—	58	—	—	—	58
Balance December 31, 2020	93,300	$ 93	$112,894	$ —	$ (108,658)	$ 882	$ 5,211

See the notes to consolidated financial statements.

PROPHOTONIX LIMITED AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

Years Ended December 31	**2020**	**2019**
Operating activities		
Net income	$ 1,092	$ 996
Adjustments to reconcile net income to net cash provided by operating activities:		
Stock-based compensation (benefit) / expense	58	(1,229)
Depreciation	230	189
Foreign exchange loss	(157)	214
Amortization of debt discount and financing costs	10	7
Allowance for inventories	41	180
Allowance for bad debt	(1)	9
Other changes in assets and liabilities:		
Accounts receivable	664	(23)
Inventories	58	(471)
Prepaid expenses and other current assets	210	(447)
Intangible assets, net	(48)	(82)
Deferred tax asset	—	454
Accounts payable	(536)	211
Deferred revenue	104	282
Accrued expenses	366	(45)
Other assets and liabilities	49	(42)
Net cash provided by operating activities	2,140	203
Investing activities		
Purchase of property, plant and equipment	(76)	(175)
Net cash used in investing activities	(76)	(175)
Financing activities		
Net proceeds from issuance of debt	152	—
Payments of revolving credit facilities, net	(887)	(163)
Payments for finance leases	(38)	(56)
Principal repayment of long-term debt	(131)	(93)
Net cash (used in) financing activities	(904)	(312)
Effect of exchange rate on cash	4	(178)
Net change in cash and equivalents	1,164	(462)
Cash and equivalents at beginning of period	1,477	1,939
Cash and equivalents at end of period	$ 2,641	$ 1,477
Supplemental cash flow information:		
Cash paid for interest	$ 71	$ 106

See the notes to consolidated financial statements.

(1) ORGANIZATION AND BASIS OF PRESENTATION

ProPhotonix Limited (Parent Company) and its subsidiaries (referenced in this document collectively 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, healthcare, 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 outbreak of the COVID-19 pandemic and the measures adopted by the government in the U.K. and Ireland to mitigate its spread have impacted the Company from March 2020 onwards. The outbreak of the pandemic caused the Company to shut down its U.K. manufacturing plant for a period of three weeks and its Ireland plant for a period of two weeks during 2020. Revenue decreased by $1.4 million, or 9%, for the year ended December 31, 2020 compared to the same period in 2019 due to the impact of the pandemic.

Management acted to mitigate the revenue decline brought by COVID-19 by reducing costs, deferring property rent payments and loan payments, participating in government job retention schemes and availing itself of other government support measures. As a result, the Company's operating income decreased by $0.5 million for the year ended December 31, 2020 compared to the same period in 2019 despite the $1.4 million decrease in revenue over the same periods. Operating income for the year ended December 31, 2019 includes a benefit of stock option compensation of $1.2 million whereas operating income for the year ended December 31, 2020 includes a charge of stock option compensation of $0.1 million. The Company generated $2.1 million of cash from its operating activities for the year ended December 31, 2020; repaid net debt of $0.9 million; and increased the cash position by $1.1 million from December 31, 2019.

The Company is subject to a financial covenant in relation to its loan facility, being that the historic annual debt service cover ratio shall not be less than 1.30:1. The covenant is tested annually at December 31. The Company complied with this covenant at December 31, 2020. The loan facility is due to be repaid in full on December 31, 2022.

There is still uncertainty over how the future development of the pandemic will impact the Company's business and customer demand for its products. Therefore, in assessing the going concern position of the Company, the directors have modelled a number of different cash flow forecast scenarios which cover the period until December 31, 2022 (the going concern assessment period). These forecasts take into consideration the anticipated impact of COVID-19 on the cash flow and liquidity of the Company. The Company's base case scenario forecasts a positive cash position throughout the forecast period with no covenant breaches. In the severe but plausible downside scenario that includes a revenue reduction of 20%, assuming in this scenario that gross profit margins remain consistent when compared to the prior year, variable costs decrease in line with revenue and that mitigating actions are taken such as reducing discretionary capex spend and restricting payroll increases the Company is forecast to breach its loan covenant and therefore may need to repay the outstanding loan balance at that time. However, the Company is still forecast to have sufficient cash in this scenario to repay the outstanding loan balance at this date and to continue its operations. The forecast cash position in this scenario at December 31, 2021 is $1.7 million with an outstanding loan balance of $0.3 million.

Consequently, the directors are confident that the Company will have sufficient funds to continue to meet its liabilities

(1) ORGANIZATION AND BASIS OF PRESENTATION (cont.)

as they fall due for the going concern assessment period and therefore have prepared the financial statements on a going concern basis.

Information about judgements made in applying accounting policies that have the most significant effects on the amounts recognized in the financial statements is included in the following notes:

— Note 1 – going concern: whether there are material uncertainties that may cast significant doubt on the entity's ability to continue as a going concern;
— Note 5 – impairment test of goodwill: key assumptions underlying recoverable amounts;

(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. All intercompany balances and transactions have been eliminated.

CASH AND CASH EQUIVALENTS

The Company considers all highly liquid investments with a maturity of original three months or less when purchased to be cash equivalents.

ACCOUNTS RECEIVABLE AND CONCENTRATION OF CREDIT RISK

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's exposure to credit risk is influenced mainly by the individual characteristics of each customer. Each new customer is analyzed individually for creditworthiness before the Company's standard payment and delivery terms and conditions are offered. The Company's review includes external ratings, if they are available, financial statements, credit agency information, industry information and in some cases bank references. 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 periodically reviews the collectability of its accounts receivable. Allowance for doubtful accounts are established for accounts that are deemed uncollectible. The Company also has accounts receivables insurance at its U.K. subsidiary, ProPhotonix Limited, which 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 2020 or 2019. 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 any 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:

	In thousands	
Years Ended December 31	**2020**	**2019**
Balance at beginning of period	$ 10	$ 49
Benefits from or charges to costs and expenses	(1)	(38)
Account write-offs and other deductions	—	(1)
Balance at end of period	$ 9	$ 10

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations and arises principally from the Company's receivables from customers. The carrying amounts of financial assets and contract assets represent the maximum credit exposure.

The Company limits its exposure to credit risk from trade receivables by establishing typical and maximum payment periods of 30 days and 90 days, respectively, for its customers. Credit risk is further 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 had one customer accounting for 10% or more of consolidated revenues in each of the years ended December 31, 2020 and 2019. The Company had one customer that accounted for 10% or more of the outstanding accounts receivable balance at December 31, 2020 and two such customers at December 31, 2019.

The Company maintains its cash and cash equivalents in bank deposit accounts, which at times may exceed insured limits. At December 31, 2020 and 2019, the amount in excess of governmental insurance protection was $1.6 million and $1.0 million, respectively. The Company believes it is not exposed to any significant credit risk on cash and cash equivalents.

INVENTORY

The Company values inventories at the lower of cost or net realizable value using the first in, first-out ("FIFO") method. Manufacturing overhead costs are applied to inventory at period end based upon the estimated added value of overhead in inventory. 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.

CAPITALIZATION OF SOFTWARE DEVELOPMENT FOR SALE

The Company capitalizes software development for sale in accordance with ASC 350-40. 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 incurred.

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont.)

INTANGIBLE ASSETS

The Company's intangible assets consist of capitalized software development costs and goodwill. Capitalized software development costs 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.

LEASES

The Company determines if an arrangement is a lease at inception. This determination includes the review of contracts with third parties to identify the existence of potential embedded leases. Operating leases are included in operating lease right-of-use ("ROU") assets, operating lease liabilities, current and noncurrent operating lease liabilities on the Company's consolidated balance sheets. Finance leases are included in current and long-term capital lease obligations on the Company's consolidated balance sheets.

ROU assets represent the Company's right to use an underlying asset for the lease term and the corresponding lease liabilities represent its obligation to make lease payments arising from the lease. Lease ROU assets and lease liabilities are recognized based on the present value of the future minimum lease payments over the lease term at commencement date. The lease ROU asset is reduced for tenant incentives and excludes any initial direct costs incurred. As the Company's leases do not provide an implicit rate, the net present value of future minimum lease payments is determined using the Company's incremental borrowing rate. The Company's lease terms may include options to extend or terminate the lease when it is reasonably certain the Company will exercise that option. Lease expense for minimum lease payments is recognized on a straight-line basis over the lease term.

The Company negotiated concessions in the form of rent payment deferrals for several of its leases as a result of the impact of the COVID-19 pandemic. These concessions affect only the timing, but not the amount, of total lease consideration over the term of the lease and they had no significant effect on the Company's results of operations for the year ended December 31, 2020. Thus, the Company elected to apply the lease modification guidance from *ASC Topic 842, Leases*, for the concessions which resulted in no change to its operating lease or capital lease liabilities and it classified the payment deferrals as part of other accrued expenses on its consolidated balance sheet.

INCOME (LOSS) PER SHARE

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

As of December 31, 2020, 15,204,198 shares underlying options could potentially have been included in the calculation of diluted shares. However, as the exercise price at December 31, 2020 was $0.07 per share, only 8,180,000 exercisable options were included in the calculation of earnings per share. All other options' exercise price exceeded the market price.

As of December 31, 2019, 17,350,044 shares underlying options could potentially have been included in the calculation of diluted shares. However, the exercise price for all of the underlying options and warrants exceeded the market price or were unvested, thus none of those shares were included in the calculation of earnings per share.

REVENUE RECOGNITION

The Company only has revenue from customers. The Company recognizes revenue when it satisfies performance obligations under the terms of its contracts, and control of its products is transferred to its customers in an amount that reflects the consideration the Company expects to receive from its customers in exchange for those products. This process involves identifying the customer contract, determining the performance obligations in the contract, determining the contract price, allocating the contract price to the distinct performance obligations in the contract, and recognizing revenue when the performance obligations have been satisfied. A performance obligation is considered distinct from other obligations in a contract when it (a) provides a benefit to the customer either on its own or together with other resources that are readily available to the customer and (b) is separately identified in the contract. The Company considers a performance obligation satisfied once it has transferred control of a good or product to a customer, meaning the customer has the ability to use and obtain the benefit of the product.

Shipping and handling costs associated with outbound freight, after control over a product has transferred to a customer, are accounted for as a fulfillment cost and are included in cost of goods sold as incurred.

For a small number of contracts revenue is recognized over time, as the manufacturing process progresses, because of the Company's enforceable right to payment for performance completed on customized products for which the Company has no alternative use. Revenue is measured by the costs incurred to date relative to the estimated total direct costs to fulfill each contract (cost-to-cost method). Incurred costs represent work performed, which corresponds with, and thereby best depicts, the transfer of control to the customer. Contract costs include labor, materials and overhead.

Taxes assessed by a government authority that are both imposed on and concurrent with a specific revenue-producing transaction, that are collected by the Company from a customer, are excluded from sales.

The Company's primary source of revenue is from sales of its LED and Laser diodes products. It also generates revenue from Non-recurring Engineering ("NRE") services that it provides to its customers. The Company does not act as an agent in any of its revenue arrangements. Contracts with customers generally state the terms of the sale, including the quantity and price of each product purchased. Payment terms and conditions may vary by contract, although terms generally include a requirement of payment within a range of 30 to 60 days after the performance obligation has been satisfied. As a result, the contracts do not include a significant financing component. In addition, contacts typically do not contain variable consideration as the contracts include stated prices. The Company provides assurance type warranties on all of its products, which are not separate performance obligations and are outside the scope of Topic 606. See below for further details on the Company's product warranties.

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.

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont.)

Changes in the warranty reserves were as follows:

	In thousands	
Years Ended December 31	**2020**	**2019**
Balance at beginning of period	$ 164	$ 170
Charges to costs and expenses	(10)	(3)
Account write-offs and other deductions	14	(3)
Balance at end of period	$ 168	$ 164

ADVERTISING EXPENSE

The Company expenses advertising costs as incurred. Advertising expenses for the years ended December 31, 2020 and 2019 were $44,000 and $12,000, respectively.

PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment are stated at cost. The Company provides for depreciation on a straight-line basis over the assets estimated useful lives. Plant and equipment held under finance leases are amortized on a straight-line basis over the shorter of the lease term or estimated useful life of the asset. Finance 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. The Company did not have any interest and penalties related to uncertain tax positions during the years ended December 31, 2020 or 2019.

CARES Act and CAA - On March 27, 2020 and December 27, 2020, the President of the United States signed and enacted into law the *Coronavirus Aid, Relief, and Economic Security Act* (CARES Act) and the *Consolidated Appropriations Act, 2021* (CAA). Among other provisions, the CARES Act and the CAA provide relief to U.S. federal corporate taxpayers through temporary adjustments to net operating loss rules, changes to limitations on interest expense deductibility, and the acceleration of available refunds for minimum tax credit carryforwards. The CARES Act and the CAA did not have a material effect on the Company's taxes for the year ended December 31, 2020.

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont.)

STOCK-BASED COMPENSATION

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

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

During 2020 the Company recognized an expense of $0.1 million of stock-based compensation related to the options and fully vested shares issued to the directors and employees as compensation (See Note 10), all of which were charged to selling, general and administrative expense. During 2019 the Company reversed $1.2 million of stock compensation expense to selling, general and administrative expense related to the expiration of performance-based stock options that were cancelled due to non-achievement of the performance criteria.

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 accumulated other comprehensive income a separate component of stockholders' equity in the accompanying consolidated balance sheets.

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

FINANCIAL INSTRUMENTS – FAIR VALUES AND RISK MANAGEMENT

The following table presents the carrying amounts and estimated fair values of the Company's financial instruments at

December 31, 2020 and 2019. Fair value is defined as the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Years Ended December 31	**2020**		**2019**	
	Carrying amount	Fair Value	Carrying amount	Fair Value
Financial assets:				
Cash and cash equivalents	$ 2,641	$ 2,641	$ 1,477	$ 1,477
Trade accounts receivable	2,216	2,216	2,801	2,801
Financial liabilities				
Revolving credit facility	—	—	912	912
Trade accounts payable	1,460	1,460	1,941	1,941
Current portion of long-term debt	329	329	220	220
Current portion of finance lease obligations	43	43	58	58
Long-term debt obligations, net of current portion	346	346	387	387
Long-term finance lease obligations, net of current portion	23	23	40	40

The fair values of the financial instruments shown in the above table as of December 31, 2020 and 2019 represent the amounts that would be received to sell those assets or that would be paid to transfer those liabilities in an orderly transaction between market participants at that date. Those fair value measurements maximize the use of observable inputs. However, in situations where there is little, if any, market activity for the asset or liability at the measurement date, the fair value measurement reflects the Company's own judgments about the assumptions that market participants would use in pricing the asset or liability. Those judgments are developed by the Company based on the best information available in the circumstances, including expected cash flows and appropriately risk-adjusted discount rates, available observable and unobservable inputs.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments:

- Cash and cash equivalents, trade accounts receivable, revolving credit facility, trade accounts payable, current portion of debt and current portion of finance lease obligations: The carrying amounts, at face value or cost plus accrued interest, approximate fair value because of the short maturity of these instruments.
- Long-term debt obligations and long-term finance lease obligations: The fair value of the Company's long-term debt and finance lease obligations are determined by discounting the future cash flows of each instrument at rates that reflect rates currently observed in publicly traded debt markets for debt of similar terms to companies with comparable credit risk.

Liquidity risk is the risk that the Company will encounter difficulty in meeting the obligations associated with its financial liabilities that are settled by delivering cash or another financial asset. The Company's objective when managing liquidity is to ensure, as far as possible, that it will have sufficient liquidity to meet its liabilities when they are due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the Company's reputation.

The Company aims to maintain the level of its cash and cash equivalents at an amount in excess of expected cash outflows on financial liabilities, excluding accounts payable, over the next 60 days. The company has $2.6 million of cash and $0.7 million of debt and capital lease obligations as of December 31, 2020 as compared to $1.4 million of cash and $1.6

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont.)

million of debt and capital lease obligations as of December 31, 2019. Additionally, its current ratio improved from 1.7 as of December 31, 2019 to 2.0 as of December 31, 2020. The Company also monitors the level of expected cash inflows on trade and other receivables together with expected cash outflows on trade and other payables.

At December 31, 2020 and 2019, the company's trade and other receivables maturing within three months was $2.1 million and $2.3 million, respectively, and the expected cash outflows from trade and other payables due within three months at December 31, 2020 and 2019 were $1.4 million and $1.9 million, respectively. This estimate excludes the potential impact of extreme circumstances that cannot reasonably be predicted, such as natural disasters. The decrease in expected cash inflows from trade receivables compared with the prior year is largely attributable to the overall decrease in revenue the Company experienced as a result of the COVID-19 pandemic.

The Company availed itself of Government loans relating to liquidity constraints arising from the COVID-19 pandemic. The impact of those steps on the consolidated financial statements is described in the Government Grants section of this footnote.

GOVERNMENT GRANTS

United States PPP Loan - On May 5, 2020, the Company received loan proceeds in the amount of $0.1 million under the Paycheck Protection Program ("PPP). The PPP, established as part of the Coronavirus Aid, Relief and Economic Security Act ("CARES Act"), provides for loans to qualifying businesses. The Company determined it qualified for the PPP loan as its business was negatively impacted by the coronavirus pandemic. The PPP loan and accrued interest are forgivable to the extent the proceeds of the loan are used for eligible expenditures such as payroll and other expenses as described in the CARES Act.

The Company has accounted for the PPP loan in accordance with ASC 450-30, *Contingencies: Gain Contingencies*. The loan amount of $0.1 million is included in short term debt in the accompanying consolidated balance sheet as of December 31, 2020. This loan was forgiven by the U.S. Small Business Association on January 25, 2021, on which date the Company's obligation to repay the loan was effectively eliminated.

Wage Subsidy Schemes - The Company's ProPhotonix (IRL) Limited and ProPhotonix Limited U.K. subsidiaries each received grants related to wage subsidy programs introduced in the United Kingdom and Ireland in response to the COVID-19 coronavirus pandemic. In the United Kingdom, the Company was entitled to the wage subsidy for furloughed or reduced employee hours from March 2020 to December 2020. In Ireland, the Company qualified for the grant due to a reduction in 2020 revenue compared to 2019 resulting from a decline in sales orders and delays in the Company's supply chain. From March to December 2020, the Company received $0.3 million and $0.2 million from the wage subsidy program in Ireland and the United Kingdom, respectively. These grants were recorded as a reduction in cost of revenue and operating expenses of $0.3 and $0.2 respectively for the twelve months ended December 31, 2020. There is no outstanding amount receivable from governments related to these grants as of December 31, 2020. The Company believes the receipt of funds under the schemes meets the qualifications and use requirements of the programs.

Horizon Research In November 2018, the Company entered into a European Union (EU) funded Horizon 2020 Research to Innovation Grant to partner with other participants in the development of a high quality water enhancement system. During 2019, the Company received advanced funding of $0.4 million. During the years ended December 31, 2020 and 2019, the Company used $0.2 million and $27,000, respectively, of the grant and recorded it as a reduction in its operating expenses. At December 31, 2020, the Company held $0.2 million of unspent grant cash recorded as a concurrent liability on its consolidated balance sheet.

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont.)

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.

RECENTLY ADOPTED ACCOUNTING PRONOUNCEMENTS

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*, which requires lessees to recognize leases on-balance sheet and disclose key information about leasing arrangements. Topic 842 establishes a ROU model that requires a lessee to recognize a ROU asset and lease liability on the balance sheet for all leases with a term longer than 12 months. Leases are classified as finance or operating, with classification affecting the pattern and classification of expense recognition in the income statement.

Additionally, in 2018 through 2020, the FASB issued the following Topic 842-related ASUs:

• 2018-01, *Land Easement Practical Expedient for Transition to Topic 842*, which clarifies the applicability of Topic 842 to land easements and provides an optional transition practical expedient for existing land easements.

• 2018-10, *Codification Improvements to Topic 842, Leases*, which makes certain technical corrections to Topic 842.

• 2018-11, *Leases (Topic 842): Targeted Improvements,* which allows companies to adopt Topic 842 without revising comparative period reporting or disclosures and provides an optional practical expedient to lessors to not separate lease and non-lease components of a contract if certain criteria are met.

• 2019-01, *Leases (Topic 842): Codification Improvements,* which provides guidance for certain lessors on determining the fair value of an underlying asset in a lease and on the cash flow statement presentation of lease payments received. ASU 2019-01 also clarifies disclosures required in interim periods after adoption of ASU 2016-02 in the year of adoption.

• 2019-10, *Financial Instruments – Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842), Effective Dates*, which defers the effective date of ASU 2016-02 and all related Topic 842 ASUs by one year to January 1, 2021, with early adoption permitted.

The ASUs issued in 2018 and 2019 for Topic 842 are effective for the Company at the same time as it adopts ASU 2016-02. However, ASU 2018-01 and the amendments related to lessors in ASU 2018-11 and ASU 2019-01 did not have a material effect on the Company's 2020 and 2019 consolidated financial statements because the Company does not enter into land easement arrangements and it is not a lessor. The Company adopted ASU 2016-02 on January 1, 2019 using a modified retrospective transition approach as of the effective date as permitted by the amendments in ASU 2018-11. As a result, the Company was not required to adjust its comparative period financial information for effects of the standard or make the new required lease disclosures for periods before the date of adoption (i.e. January 1, 2019). The Company has elected to adopt the package of transition practical expedients and, therefore, has not reassessed (1) whether existing or expired contracts contain a lease, (2) lease classification for existing or expired leases or (3) the accounting for initial direct costs that were previously capitalized. The Company did not elect the practical expedient to use hindsight for leases existing at the adoption date.

The adoption of ASU 2016-02 had a material effect on the Company's consolidated balance sheet but did not materially affect the consolidated statement of income. The most significant changes to the consolidated balance sheet relate to the recognition of new ROU assets and lease liabilities for operating leases. The Company's accounting for finance leases remains substantially unchanged. The adoption of ASU 2016-02 also had no material effect on operating, investing, or financing cash flows in the consolidated statement of cash flows. However, ASU 2016-02 has significantly affected the Company's disclosures about noncash investing and financing activities. Additionally, the Company's lease-related disclosures have significantly increased as of and for the year ended December 31, 2020 as compared to prior years. See Note 13.

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont.)

As a result of adopting ASU 2016-02, the Company recognized additional operating liabilities of $0.3 million (of which $0.1 million was current and $0.2 million was noncurrent) with corresponding ROU assets of the same amount as of January 1, 2019.

In January 2017, the FASB issued ASU 2017-04, Intangibles – Goodwill and Other (Topic 350) ("ASU 2017-04") related to measurements of goodwill. ASU 2017-04 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 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 adoption of ASU 2017-04 did not have a material effect on the Company's consolidated financial statements.

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In December 2019, the FASB issued ASU 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*, which removes certain exceptions for recognizing deferred taxes for investments, performing intraperiod allocation and calculating income taxes in interim periods. The ASU also adds guidance to reduce complexity in certain areas, including recognizing deferred taxes for tax goodwill and allocating taxes to members of a consolidated group. ASU 2019-12 is effective for the Company's annual periods beginning after December 15, 2021. Early adoption is permitted. The Company is currently evaluating the effect the adoption of ASU 2019-12 will have on its consolidated financial statements.

(3) 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:

	In thousands	
Years Ended December 31	**2020**	**2019**
Finished goods	$ 459	$ 722
Work-in-process	607	456
Raw materials	2,458	2,188
Gross inventories	$ 3,524	$ 3,366
Inventory reserves	(873)	(782)
Net inventories	$ 2,651	$ 2,584

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.

(4) PROPERTY, PLANT AND EQUIPMENT

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

	In thousands	
Years Ended December 31	**2020**	**2019**
Buildings and building improvements	$ 263	$ 249
Computer equipment	513	477
Machinery and equipment	2,472	2,257
Furniture and fixtures	549	488
Property, plant and equipment	$ 3,797	$ 3,471
Less accumulated depreciation	(3,285)	(2,898)
Net property, plant and equipment	$ 512	$ 573

Depreciation expense from operations was $0.2 million for each of the years ended December 31, 2020 and 2019.

(5) GOODWILL

The Company adopted ASU 2017-04, Intangibles – Goodwill and Other (Topic 350) (“ASU 2017-04”) related to measurements of goodwill during the year ended December 31, 2020. ASU 2017-04 eliminates the requirement to calculate the implied fair value of goodwill and instead allows entities to record an impairment charge based on the excess of a reporting unit’s carrying value over its fair value.

The Company operates in two reporting units: LED’s (light emitting diode systems) and Laser & Diodes. Goodwill as of December 31, 2020 and 2019 relates to the LED reporting unit. The forecasts of discounted cash flows used in estimating the fair value of the LED reporting unit requires that certain assumptions and estimates be made regarding industry economic factors and future profitability of the reporting unit to assess the need for an impairment charge. This approach used multiple cash flow projections taking into consideration assumed probabilities of different future events and/or scenarios instead of a single cash flow scenario. While many scenarios and probabilities may exist, management ultimately believes that the three scenarios detailed below (downside, base case and upside) reflect a representative sample of possible outcomes.

The calculations use cash flow projections that are based on financial budgets and business plans prepared by management and approved by the board of directors. The budgets and business plans are updated to reflect the most recent developments as at the reporting date. Management’s expectations reflect performance to date and are based on its experience in times of recession and consistent with the assumptions that a market participant would make.

For each scenario, management has assigned probability weights. The recoverable amount was estimated by calculating the present value of the probability-weighted expected cash flows. The fair value measurement was categorized as a Level 3 fair value based on the inputs and the valuation technique used.

In 2020, the Company changed its valuation technique used to estimate the recoverable amount from the traditional approach (the discount rate adjustment method), which uses a single cash flow scenario, to the expected cash flow approach, which uses multiple, probability-weighted cash flow scenarios. The change in valuation technique is due to the significantly higher degree of estimation uncertainty and wider range of possible cash flow projections following the impact of the COVID-19 pandemic.

The upside scenario reflects a 22% revenue increase in 2021 and then that growth rate decreases over the ensuing three years such that the average growth rate over the period from 2021 to 2024 is 10%. The 22% increase in revenue for 2021 is based on a statistical forecast of the LED reporting unit’s revenue from the periods before the COVID-19 pandemic. The budgeted operating profit margin for these scenarios are 10% (2020: 5%) due to the increase in revenue.

The base case scenario reflects an 11% increase in 2021 revenue and a 6% average growth rate in revenue from 2021 to 2024. This reflects a return to the pre-crisis levels of revenue. The budgeted operating profit margins for these scenarios are 3% due to the flat revenue compared to pre-crisis revenue levels.

The downside scenario reflects a continuing negative impact of COVID-19 on the LED reporting unit’s revenue wherein 2021 revenue decreases by a further 6% as compared to the already crisis reduced revenue of 2020 resulting in an average revenue from 2021 to 2024 that is below the pre-crisis revenue. The budgeted operating profit margin is 0% due to the decrease in revenue.

The cash flow projections for the upside, base case and downside scenarios included specific estimates for four years and a terminal growth rate thereafter. The key assumptions used in estimating the estimated fair value at December 31, 2020 are set out on the following page.

(5) GOODWILL (cont.)

	Downside	Base case	Upside
Probability Weights	20%	70%	10%
Discount rate (post-tax)	16.6%	16.6%	16.6%
Average operating profit margin (2021-22)	-2%	1%	9%
Average operating profit margin (2023-24)	3%	5%	12%
Terminal value growth rate	1.5%	1.5%	2.0%

The key assumptions in the table above are based on the following.

— Probability weights: Management has subjectively assigned probability weights to each scenario based on its experience in times of recession and its expectations for the economy under and following the COVID-19 pandemic. Management believes that the probability weight assignment presents a reasonable assessment of the likelihood of the scenarios, taking into account the potential for a more robust recovery on the upside and the risk of bankruptcy on the downside.

— Discount rate: The discount rate used is the weighted-average cost of capital (WACC). The discount rate does not reflect risks for which the estimated cash flows have been adjusted. The discount rate is a post-tax measure based on the rate of 20-year government bonds issued by the most creditworthy government in the relevant market and in the same currency as the cash flows, adjusted for a risk premium to reflect both the increased risk of investing in equities generally and the risk of the LED reporting unit.

— Average operating profit margin (2021–22): The average operating profit margins were estimated taking into account potential further reductions in operating expenses in 2021 under the downside scenario. The average operating profit margins are based on the revenue growth rates in 2021–23, which have been determined considering the expected economic conditions in 2021–23 under each scenario.

— Average operating profit margin (2023-24): The average operating profit margins reflect the expected revenue growth rates in 2023–24. The pre-crisis operating profit margin is -1% for the LED reporting unit.

— Terminal value growth rate: The long-term growth rate into perpetuity has been determined as the compound annual EBITDA growth rate estimated by management. The terminal growth rate for the base case and downside scenarios of 1.5% has been reduced to reflect potential long-term effects of the crisis on GDP.

The assumptions used in estimating the recoverable amount are consistent with the assumptions that a market participant would make.

The estimated fair value of the LED reporting unit exceeded its carrying amount by $0.1 million in the downside scenario. Further reduction in revenue from that which was used in the downside scenario would eventually lead to impairment. However, the estimated fair value exceeded its carrying amount by $1.2 million in the base case scenario, which management believes to be most likely, so no adjustment is required for impairment.

The changes in the carrying amount of goodwill for the years ended December 31, 2020 and 2019 were as follows:

	In thousands	
Years Ended December 31	**2020**	**2019**
Balance at beginning of period	$ 397	$ 405
Effect of exchange rate	35	(8)
Balance at end of period	$ 432	$ 397

(6) INTANGIBLE ASSETS

Intangible assets consists of capitalized software development costs. The Company capitalizes these costs in accordance with ASC-350; 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 released to production, all future software de-bug costs are expensed in the period incurred. There are no intangible assets with indefinite lives. Intangible assets and their respective useful lives are as follows:

	Useful Life
Capitalized software development costs	5 Years

Gross carrying amounts and accumulated amortization of intangible assets were as follows as of December 31, 2020 and 2019. The gross carrying values and the accumulated amortization values are impacted by the foreign currency translation adjustment.

	In thousands	
Years Ended December 31	2020	2019
Gross carrying amount of capitalized software development costs	$ 585	$ 439
Accumulated amortization	(127)	(62)
Net balance	$ 458	$ 377

(7) DEBT

		In thousands	
Years Ended December 31		2020	2019
Senior Fixed Rate Secured Term Note with KKV ("KKV Note"), maturing on December 31, 2022 with an interest rate of 10%, at December 31, 2020.	Total debt less unamortized debt issuance costs	$ 519	$ 607
PPP loan with Enterprise Bank and Trust Company maturing on May 5, 2025 with an interest rate of 1% at December 31, 2020	Total debt	86	
Bounce Back Loan with HSBC UK Bank plc maturing on May 5, 2026 with an interest rate of 2.5% at December 31, 2020	Total debt	68	—
Borrowings under Revolving Credit facility with Barclays Bank Sales Financing with an interest rate of 2.0% above Barclays' base rate at December 31, 2020 (2.25% as of December 31, 2019).	Principal Amount	—	912
		673	1,519
	Less: Revolving Credit Facility		(912)
	Less: current portion of long-term debt	(338)	(220)
	Long-term debt less unamortized discount and debt issuance costs	$ 335	$ 387

The Company made $0.1 million in interest payments during 2020 and is expected to make $45,000 in interest payments during the year ended December 31, 2021. Scheduled future maturities of debt, excluding interest payments and the effect of unamortized debt issuance costs, for the next five years are as follows:

	In thousands					
Due by period	2021	2022	2023	2024	2025+	Total
Debt obligations	$ 344	$ 289	$ 14	$ 14	$ 18	$ 679

(7) DEBT (cont.)

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, from KKV Investment Management Ltd., formerly SQN Secured Income Fund PLC, ("KKV Note") in the original principal amount of £0.7 million ($0.9 million at June 14, 2018) secured by certain assets of ProPhotonix (IRL) Limited.

The Company received a six-month deferral of loan principal payments during the year ended December 31, 2020 which extended the loan maturity to December 31, 2022. During the six-month deferral period, the Company continued to make interest payments totaling $26,000 as scheduled. The Company has determined that the loan modification does not meet the criteria for troubled debt restructuring under ASC 470-50, Debt—Modifications and Extinguishments, and that the terms of the modified loan are not substantially different from the original terms of the loan. Therefore, the Company accounted for the loan modification as a continuation of the loan and there was no material impact to its consolidated financial statements.

The company did not breach its debt covenant ratio as of December 31, 2020 or 2019.

PPP loan

On May 5, 2020, the Company received loan proceeds in the amount of $0.1 million under the Paycheck Protection Program ("PPP). The PPP, established as part of the Coronavirus Aid, Relief and Economic Security Act ("CARES Act"), provides for loans to qualifying businesses. The Company determined it qualified for the PPP loan as its business was negatively impacted by the coronavirus pandemic.

The loan bears interest at a rate of 1% and is payable in monthly installments of principal and interest over two years, beginning six months from the date of the note. The loan may be repaid at any time with no prepayment penalty. On June 3, 2020, the Paycheck Protection Program Flexibility Act of 2020, was enacted which extended the repayment period from two years to five years and the deferral payment period from six months to ten months.

The Company has accounted for the PPP loan in accordance with ASC 450-30, *Contingencies: Gain Contingencies*. The loan amount of $0.1 million is included in short term debt in the accompanying consolidated balance sheet as of December 31, 2020. This loan was forgiven by the U.S. Small Business Association on January 25, 2021, on which date the Company's obligation to repay the loan was effectively eliminated.

ProPhotonix Limited Bounce Back Loan

On May 6, 2020, the Company received loan proceeds in the amount of $0.1 million under the U.K. government's Bounce Back Loan Scheme (BBL Scheme) which provides loans to small and medium sized business who have been negatively affected by the coronavirus pandemic. The loan bears interest at a rate of 2.5% and is payable in 60 monthly installments beginning 13 months from the date of the loan. $0.1 million of the loan amount is included in long-term debt obligations and $8,000 is included in short-term debt obligations in the accompanying consolidated balance sheet as of December 31, 2020.

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.

(7) DEBT (cont.)

The most recent amendment of February 10, 2017, 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, 2018 with a rolling evergreen provision which extended through April 22, 2020. The Company chose not to renew the facility with Barclays and fully paid the outstanding balance during 2020.

(8) 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, 2020. The Company had deferred tax assets, before considering the full valuation allowance, totaling $13.1 million and $14.4 million as of December 31, 2020 and 2019, respectively.

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.

Based on the size of the Company's historical operating losses, there is some doubt as to when, if ever, any of the deferred tax assets related to its 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 and adjusted for reversals of compensation expense for grants outstanding as of the end of the year (fully or partially vested) times the appropriate tax rate. 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., the United Kingdom, Ireland and various states and local jurisdictions. As a result of the Company's tax loss position, the tax years 2002 through 2020 remain open to examination by the federal and most state tax authorities in the U.S. In addition, the tax years 2013 through 2020 are open to examination in foreign jurisdictions.

For the years ended December 31, 2020 and 2019, income from continuing operations before taxes consists of the following:

	In thousands	
Years Ended December 31	**2020**	**2019**
U.S. operations	$ 120	$ 1,405
Foreign operations	551	(352)
Net income before provision for income taxes	$ 671	$ 1,053

Income tax benefit attributable to income from continuing operations was $0.4 million for the year ended December 31, 2020 and income tax expense attributable to income from continuing operations was $0.1 million for the year ended December 31, 2019, and differed from the amounts computed by applying the statutory income tax rate of 21%, to pretax income from continuing operations as a result of the following:

(8) TAXES (cont.)

Years Ended December 31	2020	In thousands 2019
Computed "expected" tax expense	$ (142)	$ (222)
Increase (reduction) in income taxes resulting from:		
Change in valuation allowance	737	231
Foreign tax rate differential	39	(33)
Adjustments in respect of prior periods	164	(2)
Non-deductible items	(377)	(31)
Income tax benefit (expense)	$ 421	$ (57)

The significant items comprising the deferred tax asset and liability at December 31, 2020 and 2019 are as follows:

Years Ended December 31	In thousands 2020	2019
Domestic net operating loss carry forwards	$ 12,631	$ 12,649
Foreign net operating loss carry forwards	1,023	1,194
R&D tax credit	525	525
Other	44	589
Valuation allowance	(14,223)	(14,957)
Deferred tax asset	$ —	$ —

As of December 31, 2020, the Company had United States federal net operating loss carry forwards (NOLs) of $60.1 million (2019: $60.2 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.

At December 31, 2019, the Company had Canadian federal NOLs of $1.1 million available to offset future taxable income, if any. The Canadian entities were dissolved in April 2020 and accordingly no Canadian NOLs exist from that date. At December 31, 2020, the Company has United Kingdom NOLs of $4.0 million (2019: $4.0 million). At December 31, 2020, the Company has an Ireland NOL of $2.5 million (2019: $2.9 million).

The Company's historical operating losses raise considerable doubt as to when, if ever, any of the deferred tax assets will be realized for its 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. The total valuation allowance against deferred tax assets decreased by $0.7 million for the year ended December 31, 2020 (2019: increased by $0.5 million).

(9) UNREGISTERED SALES OF EQUITY SECURITIES AND WARRANTS OUTSTANDING

WARRANTS

There were no warrants exercised in 2020 or 2019. As of December 31, 2019, 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	2020

As of December 31, 2020, there were no warrants outstanding.

(10) STOCK OPTION PLANS

On June 9, 2014, the Company implemented its 2014 Stock Incentive Plan (the "2014 Plan"). Under the 2014 Plan, the Company may issue options, restricted stock, restricted stock units and other stock-based awards to its employees, officers, directors, consultants and advisors. An aggregate of 10,200,000 shares of the Company's Common Stock were initially reserved for issuance under the 2014 Plan, 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, 2020, there were 17,900,000 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. The Independent Directors voluntarily refused one of their quarterly fee payments during the year ended December 31, 2020 in light of the negative impact that the COVID-19 crisis had on the Company. During the years ended December 31, 2020 and 2019 the Independent Directors each received $22,500 and $30,000 per annum of fees. On November 9, 2020 and May 16, 2019 each Independent Director received a grant of 75,000 fully vested shares of the Company's Common Stock with a total value of $4,500 and $7,200, respectively. Total directors' compensation including other benefits are disclosed on pages 17 and 18 of this Annual Report and that information forms part of the audited financial statements.

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.

The following table summarizes information about the stock options outstanding as of December 31, 2020. There was an intrinsic value on the options outstanding, and exercisable, at December 31, 2020 of $0.2 million. There was no intrinsic value of the options outstanding or exercisable as of December 31, 2029 since the fair market value was below the exercise price for all options outstanding as of that date.

(10) STOCK OPTION PLANS (cont.)

There were no options granted during the year ended December 31, 2020 or 2019. The following table summarizes information related to the outstanding and exercisable options during the years ended December 31, 2020 and 2019:

	Options Outstanding	Weighted Average Exercise Price per Share ($)	Weighted Average Remaining Contractual Term (in Years)
Balance at December 31, 2018	30,064,867	0.15	6.68
Granted	—	—	
Exercised	—	—	
Cancelled	(12,764,823)	0.22	
Balance at December 31, 2019	17,300,044	0.09	3.68
Vested and Exercisable at December 31, 2019	16,907,594	0.08	3.68
Balance at December 31, 2019	17,300,044	0.09	3.68
Granted	—	—	
Exercised	—	—	
Cancelled	(2,095,846)	0.15	
Balance at December 31, 2020	15,204,198	0.08	2.78
Vested and Exercisable at December 31, 2020	15,204,198	0.08	2.78
Vested and Expected to Vest at December 31, 2020	15,204,198	0.08	2.78

Range of Exercise Prices	Options Outstanding	Weighted Average Contractual Life (years)	Weighted Average Exercise Price	Options Exercisable	Weighted Average Exercise Price
$ 0.03 – 0.24	15,204,198	2.78	$ 0.08	15,204,198	$ 0.08

Total stock option expense recorded in 2020 was $58,000. At December 31, 2020, there was no unrecognized compensation cost related to stock options granted. During 2019 the Company reversed $1.2 million of stock compensation expense to selling, general and administrative expense related to the expiration of performance-based stock options that were cancelled due to non-achievement of the performance criteria. There were no options exercised in either 2020 or 2019.

(11) EMPLOYEE STOCK PURCHASE PLAN

In May 2000, the Company adopted the 2000 Employee Stock Purchase Plan (the Stock Purchase Plan). During the year ended 2019 there were no shares issued under the Stock Purchase Plan and it was ended on April 4, 2019 by the Board of Directors.

(12) 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

(12) EMPLOYEE DEFINED CONTRIBUTION PLANS (cont.)

Company made matching contributions of $18,000 in the year ended December 31, 2020 and $23,000 in the year ended December 31, 2019. The Company incurred costs of $2,200 in 2020 and $1,500 in 2019 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 $96,000 and $98,000 in the years ended December 31, 2020 and 2019. 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 $57,000 and $45,000 in the years ended December 31, 2020 and 2019, respectively. Plan administration costs come out of the plan itself.

(13) LEASES, OTHER OBLIGATIONS AND CONTINGENT LIABILITIES

The Company negotiated concessions in the form of rent payment deferrals for several of its leases as a result of the impact of the COVID-19 pandemic. These concessions affect only the timing, but not the amount of, total lease consideration over the term of the lease and they had no significant effect on the Company's results of operations for the year ended December 31, 2020. Thus, the Company elected to apply the lease modification guidance from *ASC Topic 842, Leases*, for the concessions and accounted for the deferred payments as increases to its operating lease liability and its capital lease liability.

Operating Leases

The Company leases office space under operating leases that expire during 2022. Rent expense on these operating leases is recognized over the term of the lease on a straight-line basis.

ProPhotonix Limited U.K. received a six-month rent deferral from April through September 2020, totaling $50,000 of which $42,000 is included in the Company's other accrued expense account as the Company has taken the practical expedient approach of ASC 842. The rent deferral resulted in an increase in the monthly lease payment from $8,000 to $10,000 beginning on October 1, 2020 through the end of the lease term.

Finance Leases

The Company utilizes, or has assumed, finance leases to finance purchases of equipment. The Company records depreciation expense on assets acquired under a finance lease in the consolidated statement of income. The current and long-term portion of finance lease obligations are recorded in current and long-term capital lease obligations on the balance sheet, respectively.

Prophotonix (IRL) Limited received a six-month deferral of rent payments on its capital leases, totaling $24,000 beginning in April 2020. The monthly payment amounts remain unchanged on these leases as the maturity date of each lease has been extended by six months.

Total office rent expense for the years ended December 31, 2020 and 2019 was $0.1 million.

(13) LEASES, OTHER OBLIGATIONS AND CONTINGENT LIABILITIES (cont.)

The components of lease expense were as follows:

	In thousands	
Years Ended December 31	**2020**	**2019**
Operating lease cost	$ 145	$ 78
Finance lease cost:		
Amortization of right-of-use assets	86	92
Interest on lease liabilities	3	9
Total lease costs	$ 234	$ 179

Other information related to leases was as follows:

	In thousands	
Years Ended December 31	**2020**	**2019**
Cash paid for amounts included in the measurement of lease liabilities		
Operating cash flows from operating leases	$ 142	$ 142
Operating cash flows from finance leases	41	60
Financing cash flows from finance leases	3	9
Weighted average remaining lease term (in years):		
Operating leases	1.7	2.6
Finance leases	1.4	2.1
Weighted average discount rate:		
Operating leases	10.0%	10.0%
Finance leases	6.3%	6.5%

Future minimum payments for operating and finance lease obligations and purchase commitments are as follows:

	In thousands	
	Finance Leases	**Operating Leases**
2021	$ 46	$ 163
2022	13	110
2023	11	—
2024	—	—
Thereafter	—	—
Total minimum lease payments	70	273
Less amount representing interest	(4)	(41)
Present value of lease liabilities	66	232
Current portion of finance lease obligations	43	—
Operating lease liabilities, current	—	117
Operating lease liabilities, noncurrent	—	73
Deferred rent	—	42
Long term finance lease obligations, net of current portion	23	—
Total lease liabilities	$ 66	$ 232

(14) LEGAL PROCEEDINGS

The Company is at times 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.

(15) DEFERRED REVENUE

At December 31, 2020 and 2019, the Company had a total of $1.0 million and $0.8 million in deferred revenue, respectively. Recognition of this revenue is subject to performance obligations that exist under the customer contracts associated with this deferred revenue balance. The Company expects to meet the performance obligations and recognize the associated revenue over the period from 2021 through 2022.

(16) SEGMENT INFORMATION

Operating segments are identified as components of an enterprise about which separate discrete financial information is available for evaluation by the Company's chief operating decision-maker. 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 chief operating decision maker and the board of directors of each operating segment review operating profit (loss) to evaluate segment performance and allocate resources to the overall business. They also review revenue, which is included withing operating profit (loss).

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

The operating profit / (loss) for each segment includes selling, research and development and expenses directly attributable to the segment. 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.

The Company had one customer account for $1.6 million, or 12%, of its total consolidated revenues in 2020 and the same customer accounted for $2.1 million, or 14%, of its total consolidated revenues in 2019. All of this customer's revenues were generated in the Company's Laser & diodes segment.

	In thousands	
Years Ended December 31	**2020**	**2019**
Revenues:		
LEDs	$ 6,909	$ 7,699
Laser & diodes	6,649	7,277
Total revenues	$ 13,558	$ 14,976
Gross profit:		
LEDs	$ 2,936	$ 3,133
Laser & diodes	2,760	2,874
Total gross profit	$ 5,696	$ 6,007
Operating profit (loss):		
LEDs	$ 386	$ 594
Laser & diodes	204	501
Total operating profit (loss)	$ 590	$ 1,095

(16) SEGMENT INFORMATION (cont.)

Years Ended December 31	2020 (In thousands)	2019 (In thousands)
Current assets:		
LEDs	$ 2,793	$ 2,358
Laser & diodes	2,416	3,581
Corporate	2,783	1,601
Total current assets	$ 7,992	$ 7,540
Property, plant & equipment:		
LEDs	$ 251	$ 289
Laser & diodes	254	271
Corporate	7	13
Total property, plant & equipment	$ 512	$ 573
Goodwill:		
LEDs	$ 432	$ 397
Laser & diodes	—	—
Corporate	—	—
Total goodwill	$ 432	$ 397
Other assets:		
LEDs	$ 524	$ 457
Laser & diodes	199	307
Corporate	54	91
Total other assets	$ 777	$ 855
Total assets:		
LEDs	4,000	3,501
Laser & diodes	2,869	4,159
Corporate	2,844	1,705
Total assets	$ 9,713	$ 9,365

Revenues by geographic area are as follows:

Years Ended December 31	2020 (In thousands)	2019 (In thousands)
United States	$ 6,847	$ 5,550
Canada, Mexico and South America	116	323
Europe	4,837	8,962
Asia and rest of world	1,758	1,566
Total	$ 13,558	$ 16,401

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

Years Ended December 31	2020 (In thousands)	2019 (In thousands)
United States and North America	$ 7	$ 13
Europe	683	686
United Kingdom	254	271
Total	$ 944	$ 970

(17) SUBSEQUENT EVENTS

The Company has evaluated subsequent events through March 24, 2021, the date which the financial statements were available to be issued. On February 18, 2021, the Company secured a second PPP loan from the U.S. Small Business Administration in the amount of $0.1 million. The loan bears interest at a rate of 1% and is payable in monthly installments of principal and interest over five years, beginning ten months from the date of the note. The loan may be repaid at any time with no prepayment penalty. The loan and accrued interest are forgivable to the extent the proceeds of the loan are used for eligible expenditures such as payroll and other expenses as described in the CARES Act.

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