

FINANCIAL HIGHLIGHTS

<i>For the Years Ended June 30</i>	1998	1997	1996	1995	1994
STATEMENT OF OPERATIONS DATA					
Sales	\$ 11,194,212	\$ 5,503,800	\$ 362,118	\$ 489,350	\$ 9,350
Operating loss	(13,692,861)	(10,066,654)	(7,824,564)	(5,755,807)	(2,568,890)
Net loss	(15,012,991)	(8,233,856)	(7,593,312)	(5,426,747)	(2,524,516)
Basic and diluted net loss per common share	\$ (1.44)	\$ (0.90)	\$ (1.22)	\$ (0.91)	\$ (0.69)
Basic and diluted weighted average number of common shares outstanding	10,428,520	9,173,419	6,235,291	5,996,162	3,645,960
BALANCE SHEET DATA					
Working capital	\$ 41,375,073	\$ 27,013,450	\$ 39,939,529	\$ 3,372,419	\$ 8,896,836
Total assets	53,488,759	35,582,087	42,367,855	4,875,715	9,800,797
Long-term debt	8,871	37,725	57,868	22,632	-
Shareholders' equity	49,336,904	32,397,043	40,588,337	3,976,689	9,393,080

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O V E R V I E W

Urologix, Inc., incorporated in 1991, develops, manufactures and markets minimally invasive medical devices for the treatment of urological diseases. The Company has developed the Targis System, a nonsurgical, anesthesia-free, catheter-based therapy that uses a proprietary microwave technology for the treatment of benign prostatic hyperplasia (BPH), a disease that affects over 23 million men worldwide. In August 1997, the Company received Food and Drug Administration (FDA) approval to market the Targis System in the United States and launched the Targis System in the United States during the fourth calendar quarter of 1997. Regulatory approvals necessary to market the Targis System in Japan and the European Union countries were obtained in fiscal year 1997. The Company's Targis System consists of a control unit and a procedure kit, which includes the microwave delivery system incorporated in a catheter, a cooling bag and a rectal thermosensing unit.

The Company markets the Targis System through a direct sales force in the United States. Internationally, the Company has developed broad-based relationships with two parties for market development and sales of the Targis System. Boston Scientific Corporation, a worldwide developer, manufacturer and marketer of medical devices, has exclusive distribution rights for the Targis System in all countries outside the United States, except Japan. Nihon Kohden Corporation, a major Japanese developer, manufacturer and marketer of medical devices, has exclusive distribution rights for the Targis System in Japan.

Since inception, the Company has experienced operating losses and anticipates that its operating losses will continue for the foreseeable future. Expenditures will be primarily related to the continuing Targis System market introduction in the United States, scale-up of commercial manufacturing, clinical trials and research and development activities.

The Company expects sales of the Targis System to account for all of its revenues for the foreseeable future. In the United States, the Company offers urologists or hospitals the option to purchase or lease the Targis System control unit. The leases are offered by a third-party lessor directly to the Company's customer, allowing the Company to record the transaction as a sale. Revenues from the sale of Targis System control units and disposable procedure kits are recognized upon shipment.

R E S U L T S O F O P E R A T I O N S

Fiscal Years Ended June 30, 1998 and 1997

Sales increased to \$11.2 million in fiscal year 1998 from \$5.5 million in fiscal year 1997 due to initial sales in the United States resulting from FDA commercial marketing approval and an increase in shipments of the Targis System to the Company's international distributors resulting from regulatory marketing approvals obtained in the European Union and Japan. Sales in the United States represented approximately 27% of total sales in fiscal year 1998. The Company expects to continue increasing United States sales of the Targis System in fiscal year 1999; however, international sales are expected to be minimal due to significant inventory levels of the Targis System at the Company's international distributors.

Cost of goods sold includes raw materials, labor and royalties, as well as costs incurred in connection with the production of Targis Systems. Cost of goods sold increased to \$9.2 million in fiscal year 1998 from \$4.9 million in fiscal year 1997, due primarily to the significant increase in sales and production. Cost of goods sold were impacted by two events in 1998. First, the Company wrote down finished goods inventory by \$700,000 during the third quarter as a result of a component that caused an occasional failure of

the Targis System catheters. Second, during the fourth quarter, the Company reduced its current production schedule in anticipation of introducing an upgraded catheter in fiscal year 1999, resulting in the allocation of overhead over a lower production volume. The upgraded catheter production began in July 1998. The Company expects cost of goods sold as a percentage of sales to decrease in 1999 due to higher United States sales as a percentage of total sales and efficiencies obtained from higher production volumes.

Research and development expenses include those costs associated with the development and protection of the Company's intellectual property, treatment of patients participating in clinical trials, the accumulation of outcome data to substantiate clinical results and the preparation and submission of applications for regulatory approvals. Research and development expenses in fiscal year 1998 increased to \$6.7 million from \$5.0 million in fiscal year 1997 due primarily to costs related to new and on-going clinical studies of the Targis System, product development activities related to Targis System improvements and alternative applications for the Company's technology, and the Company's settlement of litigation concerning its rights under a previous settlement agreement (see Note 5 of Notes to Financial Statements). Research and development expenses in fiscal year 1999 are expected to decrease due to the conclusion of some clinical studies, lower regulatory expenses and the recent settlement of litigation.

Sales and marketing expenses in fiscal year 1998 increased to \$6.8 million from \$3.4 million in fiscal year 1997, due primarily to costs associated with the Company's United States marketing launch of the Targis System and supporting the marketing of the Targis System in Europe and Japan. These costs included the hiring of sales and marketing management, preparation of promotional materials, recruitment of field sales representatives and efforts related to obtaining third-party reimbursement for the Targis System. The Company expects sales and marketing expenses to increase as it increases its sales efforts in the United States, including the expected expansion of its direct sales force, and continues supporting its international distributors' sales efforts.

General and administrative expenses in fiscal year 1998 increased slightly to \$2.3 million from \$2.2 million in fiscal year 1997 due to administrative costs associated with an increase in employees in connection with the Company's growth and commencement of United States sales activities.

Interest income was relatively unchanged for year 1998 compared to fiscal year 1997, primarily as a result of similar average invested balances. Litigation settlement expenses resulted from the settlement agreement described above.

Fiscal Years Ended June 30, 1997 and 1996

Sales increased to \$5.5 million in fiscal year 1997 from \$362,000 in fiscal year 1996 due to sales of the Targis System to the Company's international distributors as a result of marketing approvals obtained during fiscal 1997 in the European Union and Japan.

Costs of goods sold increased to \$4.9 million in fiscal year 1997 from \$1.2 million in fiscal year 1996 primarily due to the increase in sales of the Targis System.

Research and development expenses increased to \$5.0 million in fiscal year 1997 from \$4.8 million in fiscal year 1996 primarily due to costs associated with the filing of the Targis System pre-market approval application (PMA) with the FDA and clinical studies conducted to document the safety and efficacy of the Targis System.

Sales and marketing expenses increased to \$3.4 million in fiscal year 1997 from \$1.0 million in fiscal year 1996, primarily due to costs associated with the marketing launch of the Targis System in Europe and Japan and preparation for United States marketing launch. Preparations included the hiring of sales and marketing management, preparation of promotional materials, recruiting for field sales representatives and efforts related to obtaining medical reimbursement for the Targis System.

General and administrative expenses increased to \$2.2 million in fiscal year 1997 from \$1.2 million in fiscal year 1996 due to administrative costs associated with an increase in employees in connection with the Company's growth and commencement of sales activities, and costs related to the Company's external reporting obligations as a public company.

Interest income increased significantly during fiscal year 1997, primarily due to income from the investment of proceeds from the Company's initial public offering, completed in June 1996.

L I Q U I D I T Y A N D C A P I T A L R E S O U R C E S

The Company has financed its operations since inception through sales of equity securities and, to a lesser extent, sales of the Targis System. As of June 30, 1998, the Company had total cash, cash equivalents and available-for-sale securities of \$36.5 million and working capital of \$41.4 million.

During fiscal year 1998, the Company used \$17.3 million in operating activities, primarily reflecting the Company's net loss, an increase in inventories of \$2.2 million and an increase in accounts receivable of \$2.7 million. The Company used \$14.0 million in investing activities, primarily reflecting the net purchase of \$9.7 million in securities, \$2.2 million of the purchase of property and equipment and \$2.0 million for the purchase of other assets. The Company financed its fiscal year 1998 operating and investing activities primarily through a November 1997 secondary offering that raised net proceeds of \$31.5 million.

At June 30, 1998, the Company had committed to purchase \$2.5 million in components for the Targis Systems from a third-party vendor (see Note 5 to Notes to Financial Statements).

The Company expects to continue to incur additional losses, and will use its working capital as it incurs substantial expenses related to the Targis System market introduction in the United States, clinical trials and research and development activities. In addition, should the Company choose to rent Targis System Control Units to customers in the future, substantial capital could be required. Although the Company believes that existing cash, cash equivalents and available-for-sale securities will be sufficient to fund its operations for at least the next 24 months, there can be no assurance that the Company will not require additional financing in the future or that any additional financing will be available to the Company on satisfactory terms, if at all.

Y E A R 2 0 0 0 I S S U E

The Company is evaluating the potential impact of what is commonly referred to as the Year 2000 issue, concerning the inability of certain information systems to properly recognize and process dates containing the year 2000 and beyond. The Company has established a dedicated Year 2000 team working with every operational area throughout the Company, and this team has worked with management to commence the following steps: (i) implementing a Year 2000 Assessment and Testing Plan for all internal

information systems and other systems that contain microcontrollers that may be affected by the Year 2000 date change; (ii) implementing a Year 2000 Assessment and Testing Plan for all Company products; (iii) communicating with third parties that supply product to the Company to ensure they are addressing the Year 2000 issue; and (iv) developing contingency and disaster recovery planning to ensure Year 2000 problem resolution.

The Company has identified and tested the systems it believes are mission critical, and the test results indicate that these systems are Year 2000 compliant. The Company expects to complete testing and establish compliance with respect to all of its systems and products by December 31, 1998, subject to possible equipment upgrades during 1999 and on-going communications with third parties. Regardless of the Year 2000 compliance of the Company's systems and products, there can be no assurance that the Company will not be adversely affected by the failure of others to become Year 2000 compliant.

The Company estimates that its direct costs for Year 2000 compliance will consist of costs related to the staff time devoted to Year 2000 compliance. The Company does not expect capital expenditures will be necessary related to Year 2000 compliance. Costs and capital expenditures in these areas have not been material for historical periods.

As noted below under "Forward-Looking Statements," statements in this section that are not historical or current facts are forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, including statements regarding the timetable for Year 2000 compliance, the Company's cost and capital expenditures, the success of the Company's efforts and others' efforts to achieve compliance, and the effects of the Year 2000 issue on the Company's future financial condition and results of operations. These statements are subject to certain risks and uncertainties that could cause actual results to differ materially from historical results and those presently anticipated or projected. The following important factors, among others, could affect the accuracy of these statements: (i) the inherent uncertainty of the costs and timing of achieving compliance on the wide variety of systems used by the Company; (ii) the reliance on the efforts of vendors, customers, government agencies and other third parties to achieve adequate compliance and avoid disruption of the Company's business in early; 2000 and (iii) the uncertainty of the ultimate costs and consequences of any unanticipated disruption in the Company's business resulting from the failure of one of the Company's applications or of a third party's systems. The foregoing list is not exhaustive, and the Company disclaims any obligations subsequently to revise any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

FORWARD-LOOKING STATEMENTS

Statements included in this report that are not historical or current facts are "forward-looking statements" made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 and are subject to certain risks and uncertainties that could cause actual results to differ materially. These risks and uncertainties include: competition from other BPH treatments; the ability of the Company's distributors and representatives to successfully market and sell the Targis System; the Company's ability to manufacture the Targis Systems in sufficient quantities; the Company's ability to maintain intellectual property protection for its proprietary products and to defend its existing intellectual property rights from challenges by third parties; and the extent to which the physicians performing the Targis System procedures are able to obtain third-party reimbursement. In addition, a detailed discussion of risks and uncertainties may be found in Item 1 of the Company's annual report on Form 10K for the fiscal year ending June 30, 1998.

B A L A N C E S H E E T S

<i>As of June 30,</i>	<i>1998</i>	<i>1997</i>
A S S E T S		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 882,801	\$ 275,571
Available-for-sale securities	35,616,726	25,825,238
Accounts receivable	4,013,533	1,272,994
Inventories	4,313,895	2,119,373
Prepays and other current assets	691,102	667,593
Total current assets	45,518,057	30,160,769
PROPERTY AND EQUIPMENT:		
Leasehold improvements	1,001,934	539,039
Machinery, equipment and furniture	3,900,839	2,141,622
Less – accumulated depreciation and amortization	(1,703,293)	(832,604)
Property and equipment, net	3,199,480	1,848,057
OTHER ASSETS	4,771,222	3,573,261
	\$ 53,488,759	\$ 35,582,087
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Current maturities of capitalized lease obligations	\$ 28,138	\$ 19,531
Accounts payable	1,960,768	2,087,443
Accrued liabilities	2,154,078	1,040,345
Total current liabilities	4,142,984	3,147,319
CAPITALIZED LEASE OBLIGATIONS, <i>less current maturities</i>	8,871	37,725
Total liabilities	4,151,855	3,185,044
COMMITMENTS AND CONTINGENCIES (NOTE 5)		
SHAREHOLDERS' EQUITY (NOTE 4):		
Undesignated stock, 5,000,000 shares authorized; none issued or outstanding	–	–
Series A Junior Participating Preferred Stock, 250,000 shares authorized, none issued or outstanding	–	–
Common stock, \$.01 par value, 25,000,000 shares authorized; 11,239,892 and 9,256,594 shares issued and outstanding	112,399	92,566
Additional paid-in capital	91,016,366	59,131,097
Accumulated deficit	(41,780,353)	(26,767,362)
Net unrealized losses on investments	(11,508)	(59,258)
Total shareholders' equity	49,336,904	32,397,043
	\$ 53,488,759	\$ 35,582,087
<i>The accompanying notes to financial statements are an integral part of these balance sheets.</i>		

S T A T E M E N T S O F O P E R A T I O N S

<i>For the Years Ended June 30,</i>	<i>1998</i>	<i>1997</i>	<i>1996</i>
SALES	\$ 11,194,212	\$ 5,503,800	\$ 362,118
COST OF GOODS SOLD	9,161,708	4,866,082	1,177,455
Gross profit (loss)	2,032,504	637,718	(815,337)
COSTS AND EXPENSES:			
Research and development	6,676,716	5,048,917	4,811,165
Sales and marketing	6,764,832	3,429,443	1,006,544
General and administrative	2,283,817	2,226,012	1,191,518
Total costs and expenses	15,725,365	10,704,372	7,009,227
OPERATING LOSS	(13,692,861)	(10,066,654)	(7,824,564)
INTEREST INCOME, NET	2,056,014	1,832,798	231,252
LITIGATION SETTLEMENT EXPENSE (NOTE 5)	(3,376,144)	-	-
NET LOSS	\$ (15,012,991)	\$ (8,233,856)	\$ (7,593,312)
BASIC AND DILUTED NET LOSS PER COMMON SHARE	\$ (1.44)	\$ (0.90)	\$ (1.22)
BASIC AND DILUTED WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING (NOTE 2)	10,428,520	9,173,419	6,235,291
<i>The accompanying notes to financial statements are an integral part of these statements.</i>			

S T A T E M E N T S O F S H A R E H O L D E R S ' E Q U I T Y

	Noncumulative Convertible Preferred Stock		Common Stock		Additional Paid-In Capital	Accumulated Deficit	Net Unrealized Losses on Investments	Total Shareholders' Equity
	Shares	Amount	Shares	Amount				
BALANCE, June 30, 1995	3,603,993	\$ 36,040	1,197,904	\$ 11,979	\$14,868,864	\$(10,940,194)	\$ -	\$ 3,976,689
Issuance of preferred stock, net	638,806	6,388	-	-	4,580,676	-	-	4,587,064
Stock options exercised	-	-	160,375	1,603	63,312	-	-	64,915
Preferred stock conversion	(4,242,799)	(42,428)	4,665,154	46,652	(4,224)	-	-	-
Shares issued through								
initial public offering, net	-	-	3,105,000	31,050	39,521,931	-	-	39,552,981
Net loss	-	-	-	-	-	(7,593,312)	-	(7,593,312)
BALANCE, June 30, 1996	-	-	9,128,433	91,284	59,030,559	(18,533,506)	-	40,588,337
Stock options exercised	-	-	128,161	1,282	100,538	-	-	101,820
Change in unrealized losses on investment	-	-	-	-	-	-	(59,258)	(59,258)
Net loss	-	-	-	-	-	(8,233,856)	-	(8,233,856)
BALANCE, June 30, 1997	-	-	9,256,594	92,566	59,131,097	(26,767,362)	(59,258)	32,397,043
Stock options exercised	-	-	240,562	2,406	198,142	-	-	200,548
Shares issued through public offering, net	-	-	1,725,000	17,250	31,509,851	-	-	31,527,101
Shares issued pursuant to employee stock								
purchase plan	-	-	17,736	177	177,276	-	-	177,453
Change in unrealized losses on investment	-	-	-	-	-	-	47,750	47,750
Net loss	-	-	-	-	-	(15,012,991)	-	(15,012,991)
BALANCE, June 30, 1998	-	\$ -	11,239,892	\$112,399	\$91,016,366	\$(41,780,353)	\$(11,508)	\$49,336,904

The accompanying notes to financial statements are an integral part of these statements.

STATEMENTS OF CASH FLOWS

<i>For the Years Ended June 30,</i>	<i>1998</i>	<i>1997</i>	<i>1996</i>
OPERATING ACTIVITIES:			
Net loss	\$ (15,012,991)	\$ (8,233,856)	\$ (7,593,312)
Adjustments to reconcile net loss to net cash used for operating activities –			
Depreciation and amortization	1,619,940	431,223	128,770
Change in operating items:			
Inventories	(2,194,522)	(1,703,453)	69,713
Accounts receivable	(2,740,539)	(1,237,928)	(35,065)
Prepays and other assets	29,278	(301,617)	(193,813)
Accounts payable and accrued liabilities	987,058	1,424,064	832,458
Net cash used for operating activities	(17,311,776)	(9,621,567)	(6,791,249)
INVESTING ACTIVITIES:			
Purchases of property and equipment	(2,222,112)	(1,901,246)	(134,336)
Purchase of securities	(57,164,738)	(83,807,022)	(40,529,176)
Proceeds from sale of securities	47,421,001	98,701,702	1,972,452
Purchase of other assets, net	(2,000,000)	(3,244,620)	–
Net cash provided by (used for) investing activities	(13,965,849)	9,748,814	(38,691,060)
FINANCING ACTIVITIES:			
Proceeds from issuance of common stock, net	31,704,554	–	39,552,981
Proceeds from issuance of preferred stock, net	–	–	4,587,064
Proceeds from exercise of stock options	200,548	101,820	64,915
Payments made on capital lease obligations	(20,247)	(18,538)	(6,650)
Net cash provided by financing activities	31,884,855	83,282	44,198,310
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	607,230	210,529	(1,283,999)
CASH AND CASH EQUIVALENTS:			
Beginning of period	275,571	65,042	1,349,041
End of period	\$ 882,801	\$ 275,571	\$ 65,042
SUPPLEMENTAL CASH FLOW DISCLOSURES:			
Cash paid for interest	\$ 5,863	\$ 8,706	\$ 3,976
Noncash investing and financing activities:			
Common stock issued upon conversion of preferred stock	\$ –	\$ –	\$ 42,428

The accompanying notes to financial statements are an integral part of these statements.

NOTES TO FINANCIAL STATEMENTS

1. NATURE OF BUSINESS:

Description of Operating Activities Urologix, Inc. (Urologix or the Company) was organized to research, develop, manufacture and market innovative devices for the treatment of benign prostatic hyperplasia (BPH) and other urologic diseases. Since inception (May 29, 1991) through June 30, 1996, the Company was a development stage enterprise, having devoted substantially all of its efforts to proprietary product development and selling the Targis System to international distributors. These efforts also included raising capital, performing clinical trials, and developing commercial markets. The Company received regulatory approvals necessary to market the Targis System in the European Union countries, Japan and Canada prior to fiscal year 1998 and in August 1997, received United States Food and Drug Administration approval to market the Targis System in the United States.

Although the Company began actively selling its products during 1997 and no longer considers itself to be in the development stage, it has not operated profitably to date and there are no assurances that it will operate profitably in the future.

2. SIGNIFICANT ACCOUNTING POLICIES:

Cash and Cash Equivalents The Company classifies highly liquid investments with original maturities of 90 days or less to be cash equivalents. Cash equivalents are stated at cost, which approximates market value.

Available-for-Sale Securities The Company invests in money market funds and United States government and investment-grade corporate securities with original maturities ranging from 90 days to two years. These investments are considered to be available-for-sale, and are stated at market value, with the resulting unrealized gains or losses reported as a component of shareholders' equity.

Inventories Inventories are stated at the lower of first-in, first-out cost or market and consisted of:

<i>June 30,</i>	<i>1998</i>	<i>1997</i>
Raw materials	\$ 2,349,717	\$ 915,609
Work-in-process	132,559	352,174
Finished goods	1,831,619	851,590
	\$ 4,313,895	\$ 2,119,373

Property and Equipment Property and equipment are stated at cost. Improvements that extend the useful lives of property and equipment are capitalized at cost and depreciated over the remaining useful lives. Repairs and maintenance are charged to expense as incurred. Depreciation is provided using the straight-line method based upon estimated useful lives of three to seven years for machinery, equipment, furniture and leasehold improvements.

Other Assets Other assets consist primarily of license fees and prepaid royalties resulting from patent licensing agreements. The agreements require the Company to pay a royalty on sales of certain catheters and related systems. The license fees and amounts prepaid by the Company have been charged to expense as sales are recognized.

Research and Development Costs Research and development costs are charged to expense as incurred.

Net Loss Per Common Share Basic and diluted net loss per common share is computed by dividing net loss by the weighted average number of shares of common stock outstanding during each period. The impact of common stock equivalents has been excluded from the computation of weighted average common shares outstanding, as the effect would be antidilutive.

Use of Estimates The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The ultimate results could differ from those estimates.

Financial Instruments For most financial instruments, including cash, available-for-sale securities, accounts payable and accruals, management believes that the carrying amount approximates fair value, as the majority of these instruments are short-term in nature.

New Accounting Pronouncements The Company has adopted the provisions of Statement of Financial Accounting Standards No. 128, "Earnings Per Share" (SFAS No. 128). SFAS No. 128 establishes accounting standards for computing and presenting earnings per share. Basic earnings per common share are computed by dividing net income by the weighted average number of shares of common stock outstanding during the period. No dilution for potentially dilutive securities is included. Diluted earnings per share are computed under the treasury stock method and are calculated to compute the dilutive effect of outstanding options, warrants and other securities. The adoption had no effect on previously reported loss per share.

The Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income" (SFAS No. 130) in June 1997. SFAS No. 130 requires the disclosure of other comprehensive income in the Company's financial statements and will be adopted in fiscal year 1999. The adoption of SFAS No. 130 is not expected to have a material impact on the Company's financial statements or the disclosures contained therein.

3. INCOME TAXES:

A reconciliation of the Company's statutory tax rate to the effective rate for the years ended June 30 is as follows:

	1998	1997	1996
Federal statutory rate	34%	34%	34%
State taxes, net of federal tax benefit	6	6	6
Valuation allowance	(40)	(40)	(40)
	-%	-%	-%

As of June 30, 1998, the Company had net operating loss carryforwards of approximately \$42,000,000 for federal income tax purposes that are available to offset future taxable income through the year 2012. Certain restrictions caused by the change in ownership resulting from sales of stock will limit annual utilization of the net operating loss carryforwards. The components of the Company's deferred tax asset for the years ended June 30, is as follows:

	1998	1997	1996
Net operating loss carryforwards	\$ 16,762,000	\$ 10,151,000	\$ 6,802,000
Temporary deductible differences	228,000	160,000	870,000
Valuation allowance	(16,990,000)	(10,311,000)	(7,672,000)
	\$ -	\$ -	\$ -

4. SHAREHOLDERS' EQUITY:

Initial and Secondary Public Offerings In May 1996, the Company completed an initial public offering of 3,105,000 shares of common stock which generated net proceeds of \$39,552,981, to be used to fund research and development, clinical trials, sales and marketing activities, and fixed asset and working capital requirements.

In November 1997, the Company completed a secondary public offering of 1,725,000 shares of common stock that generated net proceeds of \$31,527,101, to be used primarily to fund the commercial launch of the Company's Targis System in the United States.

Reverse Stock Split The Company's shareholders approved a 1-for-2 reverse common and convertible preferred stock split effective April 30, 1996. The effect of the reverse stock split has been reflected for all periods presented in the accompanying financial statements.

Convertible Preferred Stock From February through June 1994, the Company issued 1,250 Series B and 2,264,292 Series C convertible preferred shares at \$4.00 and \$4.40 per share, respectively, for total net proceeds of \$9,848,050. In December 1996 and March 1997, the Company completed the sales of 312,500 and 326,306 Series D convertible preferred shares at \$8.00 per share, for total net proceeds of \$4,587,064.

In conjunction with the Company's initial public offering, all shares of convertible preferred stock were converted to 4,665,153 shares of common stock, in accordance with each Series' respective conversion ratio.

Stock Options The Company has a stock option plan (the 1991 Stock Option Plan) which provides for the granting of incentive stock options to employees and nonqualified stock options to employees, directors and consultants. As of June 30, 1998, the Company has reserved 1,950,910 shares of common stock under this plan. As of June 30, 1998, 341,634 shares were available for future grants under this plan. Options expire seven to ten years from the date of grant and are subject to varying vesting schedules. In April 1996, the Company amended the 1991 Stock Option Plan to provide for the automatic grant of 10,000 stock options to each nonemployee director upon their initial election. Options are granted at fair market value, vest over four years, and expire ten years from date of grant, or one year after the person ceases to be a director of the Company, whichever occurs earlier. In May 1998, the Company repriced certain stock options previously granted to \$8.81, the fair market value on the date of repricing.

Shares subject to option are summarized as follows:

	<i>Stock Options</i>	<i>Weighted Average Exercise Price</i>
BALANCE at June 30,1995	691,825	\$.46
Options granted	376,936	8.83
Options canceled	(454)	.60
Options exercised	(160,389)	.48
BALANCE at June 30,1996	907,918	3.93
Options granted	196,000	16.35
Options canceled	(2,020)	.60
Options exercised	(128,161)	.81
BALANCE at June 30,1997	973,737	5.47
Options granted	447,234	10.51
Options canceled	(161,885)	8.27
Options exercised	(238,312)	1.19
BALANCE at June 30,1998	1,020,774	\$ 8.23
Options exercisable at June 30,1998	394,299	\$ 5.85

The Company accounts for stock options under Accounting Principles Board Opinion No. 25, under which no compensation cost has been recognized. Had compensation cost for these options been determined consistent with SFAS No. 123, "Accounting for Stock-Based Compensation," the basic and diluted net loss and basic and diluted net loss per share would have been increased to the following pro forma amounts:

		<i>1998</i>	<i>1997</i>	<i>1996</i>
Basic and diluted net loss	As reported	\$ (15,012,991)	\$ (8,233,856)	\$ (7,593,312)
	Pro forma	(16,942,255)	(9,872,331)	\$ (7,913,515)
Basic and diluted net loss per share	As reported	\$ (1.44)	\$ (0.90)	\$ (1.22)
	Pro forma	(1.62)	(1.08)	\$ (1.27)

For purposes of calculating the above required disclosure, the fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions used for grants in 1998, 1997 and 1996, respectively: risk-free interest rates of 5.52%, 6.87% and 5.00%, no expected dividend yield; expected lives of seven years and expected volatility of 54.25%.

The weighted average fair value of options granted during 1998, 1997 and 1996 was \$10.51, \$16.35 and \$8.83, respectively. Options issued during 1998, 1997 and 1996, which remain outstanding at June 30, 1998, have an exercise price between \$.60 and \$20.88, a weighted average exercise price of \$9.43 and a weighted average remaining contractual life of 7.25 years.

1996 Employee Stock Purchase Plan In 1996, the Company adopted the 1996 Employee Stock Purchase Plan (the Plan), and reserved 100,000 common shares for issuance under the Plan. Under the terms of the Plan, employees may purchase

common shares at prices to be determined by the Company's board of directors, ranging from 85% to 100% of the shares' estimated fair market value. Eligible employees elect to participate through payroll deductions at the maximum level established by the board of directors, but not to exceed 10% of the participant's base pay, as defined. As of June 30, 1998, 17,736 shares had been purchased under the Plan for gross proceeds of \$177,543.

5. COMMITMENTS AND CONTINGENCIES:

Purchase Commitments At June 30, 1998, the Company has orders outstanding to purchase Targis Control Systems, the primary system necessary for all treatments, from a third-party vendor for a total purchase commitment of approximately \$2,500,000.

Sales Commitments The Company has signed agreements granting Boston Scientific Corporation and Nihon Kohden Corporation exclusive distribution rights of the Targis System in all geographic areas other than the United States. Nihon Kohden Corporation has exclusive distribution rights for Japan. Boston Scientific Corporation has exclusive distribution rights for the rest of the world.

Litigation In May 1998, the Company entered into a settlement agreement resolving litigation with BSD Medical Corporation (BSD) and TherMatrix, Inc. regarding a dispute about a previous settlement agreement. Pursuant to the settlement agreement, the Company paid \$5 million to BSD and TherMatrix, Inc. and will maintain its non-exclusive license to certain patents owned by BSD and TherMatrix, Inc. pertaining to transurethral insertable applicators and systems for the treatment of BPH and other urological conditions. Of the \$5 million settlement amount, \$2 million is included in Other Assets and will be amortized against future sales and the remaining \$3 million plus related legal expenses were charged to Litigation Settlement Expense for the year ended June 30, 1998.

401(k) Plan The Company provides a 401(k) savings plan to which eligible employees may make pretax payroll contributions up to 15% of compensation. Company matching contributions are discretionary, and none have been made to date.

Leases The Company leases its facility and certain equipment under noncancelable operating or capital leases, which expire at various dates through fiscal year 2003. Rent expense related to operating leases was approximately \$195,500, \$139,700 and \$102,500 for the years ended June 30, 1998, 1997 and 1996, respectively. Future minimum lease commitments under noncancelable operating and capital leases with initial remaining terms of one year or more are as follows as of June 30, 1998:

	<i>Operating Leases</i>	<i>Capital Leases</i>
Fiscal year:		
1999	\$ 280,409	\$ 31,170
2000	280,409	9,517
2001	280,409	-
2002	296,763	-
2003	205,632	-
	\$ 1,343,622	40,687
Less - imputed interest		(3,678)
Current maturities		(28,138)
Long-term capitalized lease obligations		\$ 8,871

R E P O R T O F I N D E P E N D E N T P U B L I C A C C O U N T A N T S

T O U R O L O G I X , I N C . :

We have audited the accompanying balance sheets of Urologix, Inc. (a Minnesota corporation) as of June 30, 1998 and 1997, and the related statements of operations, shareholders' equity and cash flows for each of the three fiscal years in the period ended June 30, 1998. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Urologix, Inc. as of June 30, 1998 and 1997, and the results of its operations and its cash flows for each of the three fiscal years in the period ended June 30, 1998, in conformity with generally accepted accounting principles.

ARTHUR ANDERSEN LLP

Minneapolis, Minnesota,
August 31, 1998

C O R P O R A T E I N F O R M A T I O N

DIRECTORS

Mitchell Dann
Chairman of the Board – Urologix, Inc.
President – M. Dann & Co., Inc.

Buzz Benson
Managing Director
Piper Jaffray Ventures

Janet G. Effland
Managing Director
Patricof & Co. Ventures, Inc.

Paul A. LaViolette
Senior Vice President and Group President
Boston Scientific Corporation

Jack E. Meyer
Former President and Chief Executive Officer
Urologix, Inc.

Robert R. Momsen
General Partner – InterWest Partners

David C. Utz, M.D.
Professor – Mayo Medical School
Consultant Emeritus – Mayo Clinic, Scottsdale

OFFICERS

John P. Costello
Executive Vice President, Sales and Marketing

Wesley E. Johnson, Jr.
Vice President, Finance
Chief Financial Officer and Secretary

David W. Powell
Vice President, Operations

W. Allen Putnam
Vice President, Regulatory and Quality

Rob ten Hoedt
Vice President, Europe

INDEPENDENT PUBLIC ACCOUNTANTS

Arthur Andersen LLP
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Minneapolis, MN 55402

CORPORATE OFFICES

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Minneapolis, MN 55447
(612) 475-1400

STOCK TRANSFER AGENT AND REGISTRAR

Norwest Bank Minnesota, N.A.
Post Office Box 64854
St. Paul, MN 55164-0854
(800) 468-9716

SECURITIES INFORMATION

The Company's shares are publicly traded on the Nasdaq Stock Market under the symbol ULGX. On September 15, 1998, the Company had 291 shareholders of record. The Company has never paid cash dividends on its Common Stock. The Board of Directors of the Company currently intends to retain any and all income for use in the Company's business and does not anticipate paying any cash dividends in the foreseeable future. Following are the quarterly high and low closing prices of the Company's common stock as reported on the Nasdaq Stock Market.

<i>Fiscal Quarter</i>	<i>First</i>	<i>Second</i>	<i>Third</i>	<i>Fourth</i>
1998:				
High	23¼	25¼	19⅞	11⅞
Low	16	16¼	8¼	8¼
1997:				
High	15¼	16½	19⅞	18⅞
Low	10⅞	13¼	15	12⅞

FORM 10-K AVAILABILITY

The Company will furnish to any shareholder, without charge, a copy of the Company's annual report filed with the Securities and Exchange Commission on Form 10-K for the 1998 fiscal year upon written request from the stockholder addressed to:

Secretary
Urologix, Inc.
14405 Twenty-First Avenue North
Minneapolis, MN 55447

For additional information about the Company, visit our Internet website at www.urologix.com

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