

Financial Highlights

For the Years Ended June 30	1999	1998	1997	1996	1995
Statement of Operations Data					
Sales	\$ 6,109,890	\$ 11,194,212	\$ 5,503,800	\$ 362,118	\$ 489,350
Operating loss	(15,762,198)	(13,692,861)	(10,066,654)	(7,824,564)	(5,755,807)
Net loss	(14,015,770)	(15,012,991)	(8,233,856)	(7,593,312)	(5,426,747)
Basic and diluted net loss per common share	\$ (1.24)	\$ (1.44)	\$ (.90)	\$ (1.22)	\$ (.91)
Basic and diluted weighted average number of common shares outstanding	11,346,148	10,428,520	9,173,419	6,235,291	5,996,162
Balance Sheet Data					
Working capital	\$ 28,803,205	\$ 41,375,073	\$ 27,013,450	\$ 39,939,529	\$ 3,372,419
Total assets	38,988,032	53,488,759	35,582,087	42,367,855	4,875,715
Long-term debt	2,723	8,871	37,725	57,868	22,632
Total shareholders' equity	35,466,643	49,336,904	32,397,043	40,588,337	3,976,689

Management's Discussion and Analysis

Overview

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 one-time, minimally invasive treatment that uses a proprietary microwave technology to treat 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. Regulatory approvals necessary to market the Targis System in Japan and the European Union countries were obtained in fiscal 1997. The Company's Targis System consists of a control unit and a procedure kit that includes the microwave delivery system incorporated in a catheter, a cooling bag and a rectal thermosensing unit.

The Company markets the Targis System in the United States through a direct sales force and its co-marketing partner, Boston Scientific Corporation ("Boston Scientific"), a worldwide developer, manufacturer and marketer of medical devices. Urologix' direct sales force has sole responsibility for completing and transacting the sales of the Targis System, while Boston Scientific, through selected members of its Microvasive Urology sales force, assists in the promotion and marketing of the Targis System treatment among urologists throughout the United States. The Company has developed a sales and marketing team consisting of sales and marketing management, product management, communication specialists and direct sales representatives, all of whom are dedicated to marketing the Targis System.

Outside the United States, the Company has developed a relationship with Nihon Kohden Corporation ("Nihon Kohden"), a major Japanese developer, manufacturer and marketer of medical devices, for market development and sales of the Targis System in Japan. The Company has a distribution agreement with Boston Scientific covering all countries outside the United States except Japan. Under the agreement, which was amended in February 1999, Urologix has responsibility for market development of the Targis System and works with Boston Scientific to sell Targis Systems from Boston Scientific's inventory through Urologix' direct sales force in Europe. Boston Scientific compensates Urologix for Urologix' market development services.

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

Results of Operations

Fiscal Years Ended June 30, 1999 and 1998

Sales decreased to \$6.1 million in fiscal 1999 from \$11.2 million in fiscal 1998 due to a decrease in international sales. Sales in the United States represented approximately 92% of revenue in fiscal 1999, compared to 27% of revenue in fiscal 1998, representing growth in United States sales of 87% from fiscal 1998 to fiscal 1999. The Company anticipates United States sales to increase in fiscal 2000 compared to fiscal year 1999; however, international sales are expected to be minimal due to existing inventory levels of Targis Systems at the Company's international distributors.

Cost of goods sold includes raw materials, labor, overhead and royalties incurred in connection with the production of the Targis control units and disposable procedure kits. Cost of goods sold decreased to \$5.9 million in fiscal 1999 compared to \$9.2 million in fiscal 1998. The decrease in cost of goods sold is attributable primarily to decreases in sales volume. Excluding the impact of a \$1.3 million reserve for excess inventory established in fiscal 1999 and a \$700,000 inventory write down related to a bad component recorded in fiscal 1998, gross profit as a percentage of sales was 25% in 1999, relatively unchanged compared to fiscal 1998. The Company expects gross profit as a percent of sales to increase in the future as a result of higher sales in the United States and from benefits realized from reductions in product and operating costs and improvements in the manufacturing process.

Research and development expenses include those costs associated with product development, 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 decreased to \$5.1 million in fiscal 1999 from \$6.7 million in fiscal 1998, due primarily to the conclusion of several clinical studies, lower regulatory expenses and the settlement of litigation. Research and development expenses in fiscal 2000 are expected to decrease due to lower clinical study expenses, reduced staffing levels and lower regulatory expenses.

Sales and marketing expenses for fiscal 1999 were \$6.8 million, which is consistent with fiscal 1998. Additional sales and marketing costs incurred in 1999, including fees paid to Boston Scientific in connection with the domestic co-marketing agreement, were offset by payments received

from Boston Scientific for international market development services provided by Urologix. These payments were recorded as a reduction to sales and marketing expense. Sales and marketing expenses were primarily related to sales and marketing personnel, recruitment of field sales representatives, advertising and promotion, 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 and continues to support its international market development efforts.

General and administrative expenses increased to \$4.0 million in fiscal 1999 compared to \$2.3 million in fiscal 1998. General and administrative expenses for fiscal 1999 reflect a non-recurring charge of \$1.6 million incurred in connection with a reduction in workforce in October 1998 that resulted from the downward revision of the Company's sales forecast. The charge included severance costs paid to employees, future lease costs related to facilities no longer occupied and the impairment of assets no longer used as a result of the reduction in work force.

Interest income decreased to \$1.7 million for fiscal 1999 from \$2.1 million in fiscal 1998. Interest income decreased due primarily to lower cash and investment balances.

Fiscal Years Ended June 30, 1998 and 1997

Sales increased to \$11.2 million in fiscal 1998 from \$5.5 million in fiscal 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 27% of total sales in fiscal 1998.

Cost of goods sold increased to \$9.2 million in fiscal 1998 from \$4.9 million in fiscal 1997, due primarily to the significant increase in sales and production. Cost of goods sold were impacted by two events in fiscal 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 catheter. Second, during the fourth quarter, the Company reduced its current production schedule in anticipation of introducing an upgraded catheter in July 1998.

Research and development expenses in fiscal 1998 increased to \$6.7 million from \$5.0 million in fiscal 1997, primarily due to costs related to new and on-going clinical studies of the Targis System, product development activities related to Targis improvements and alternative applications for the Company's technology, and the Company's settlement of litigation concerning its rights under a previous settlement agreement.

Sales and marketing expenses in fiscal 1998 increased to \$6.8 million from \$3.4 million in fiscal 1997, due primarily to costs associated with the Company's United States marketing launch of the Targis System and marketing support of the Targis System in Europe and Japan. These costs included the hiring of sales and marketing personnel, preparation of promotional materials, and efforts related to obtaining third-party reimbursement for the Targis System.

General and administrative expenses in fiscal 1998 increased slightly to \$2.3 million from \$2.2 million in fiscal 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 fiscal 1998 compared to fiscal 1997, primarily as a result of similar average invested balances.

Liquidity and Capital Resources

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, 1999, the Company had total cash, cash equivalents and available-for-sale securities of \$28.0 million and working capital of \$28.8 million.

During fiscal 1999, the Company used \$7.6 million in operating activities, primarily as a result of the Company's net loss, a decrease in inventories of \$1.9 million and accounts receivable of \$2.7 million. The Company generated \$7.3 million in investing activities, primarily reflecting the net sale of \$8.3 million in investment securities less purchases of \$1.0 million of property and equipment. The Company financed its fiscal year 1999 operating and investing activities primarily through a November 1997 secondary offering that raised net proceeds of \$31.5 million.

At June 30, 1999, the Company did not have any significant purchase commitments.

The Company expects to continue to incur additional losses and will use its working capital as it incurs substantial expenses related to the Targis market development in the United States, clinical trials and research and development activities. In addition, the Company has commenced a program to rent Targis control units on a per-procedure basis to customers. Depending on the success of this program, the Company may use substantial capital to finance the units rented by customers.

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.

Interest Rate Risk

The fair value of the Company's investment portfolio at June 30, 1999 approximated carrying value. Increases and decreases in prevailing interest rates generally translate into decreases and increases in the fair value of these instruments. Also, fair values of interest rate sensitive instruments may be affected by the credit worthiness of the issuer; prepayment options, relative values of alternative instruments, the liquidity of the instrument and other general market conditions.

Market risk was estimated as the potential decrease in fair value resulting from a hypothetical 10% increase in interest rates for the issues contained in the investment portfolio and was not materially different from the year-end carrying value.

Year 2000 Issue

Many currently installed computer systems and software products are coded to accept, store or report only two-digit year entries in date code fields. Beginning in the Year 2000 (Y2K), these date code fields will need to accept four-digit entries to distinguish 21st century dates from 20th century dates. The Y2K issue is a result of these programs being written with two digits instead of four. As a result, computer systems and software used by companies, including Urologix and its vendors and customers, will need to comply with the Y2K requirements.

The Company is aware of the Y2K issue and has been proactive in addressing the issue internally and externally. The Company's primary software system is currently Y2K compliant. The Company does not depend on in-house custom systems and generally purchases off-the-shelf software from reputable vendors who have tested their software for Y2K compliance. The Y2K issue is being considered for all future software purchases. Although the Company believes the Y2K issue will not pose material operational

problems for its computer systems, there can be no assurance that problems arising from the Y2K issue will be completely eliminated.

The Company is evaluating significant suppliers' and large customers' systems to determine the extent to which the Company's interface with these systems is vulnerable to the Y2K issue. This process is in progress and should be completed prior to 2000.

Urologix products are Y2K compliant and are able to operate in the Year 2000 and beyond. The Company believes it has an effective program in place to resolve Y2K issues in a timely manner. The Company also has contingency plans for certain critical applications and is working on such plans for others. These contingency plans involve, among other actions, manual workarounds, increasing inventories and adjusting staffing strategies. In the event that the Company does not completely resolve all of the Y2K issues, the Company's business operations could be adversely affected, although the resulting costs and loss of business cannot be reasonably estimated at this time.

Forward-Looking Statements

Statements included in this Annual 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. A detailed discussion of risks and uncertainties may be found in the section entitled "Business-Risk Factors" in the Company's Form 10-K for the year ended June 30, 1999.

Balance Sheets

As of June 30	1999	1998
Assets		
Current Assets:		
Cash and cash equivalents	\$ 657,596	\$ 882,801
Available-for-sale securities	27,378,692	35,616,726
Accounts receivable, net of allowance of \$171,216 and \$0	1,260,810	4,013,533
Inventories	2,436,418	4,313,895
Prepays and other current assets	588,355	691,102
Total current assets	32,321,871	45,518,057
Property and Equipment:		
Leasehold improvements	742,923	1,001,934
Machinery, equipment and furniture	4,029,743	3,900,839
Less – Accumulated depreciation and amortization	(2,521,479)	(1,703,293)
Property and equipment, net	2,251,187	3,199,480
Other Assets		
	4,414,974	4,771,222
	\$ 38,988,032	\$ 53,488,759
Liabilities and Shareholders' Equity		
Current Liabilities:		
Current maturities of capitalized lease obligations	\$ 8,924	\$ 28,138
Accounts payable	836,999	1,960,768
Accrued liabilities	2,672,743	2,154,078
Total current liabilities	3,518,666	4,142,984
Capitalized Lease Obligations, less current maturities	2,723	8,871
Total liabilities	3,521,389	4,151,855
Commitments and Contingencies (Note 5)		
Shareholders' Equity:		
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; 11,428,937 and 11,239,892 shares issued and outstanding	114,289	112,399
Additional paid-in capital	91,149,858	91,016,366
Accumulated deficit	(55,796,123)	(41,780,353)
Accumulated other comprehensive loss	(1,381)	(11,508)
Total shareholders' equity	35,466,643	49,336,904
	\$ 38,988,032	\$ 53,488,759

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

Statements of Operations

For the Years Ended June 30	1999	1998	1997
Sales	\$ 6,109,890	\$ 11,194,212	\$ 5,503,800
Cost of Goods Sold	5,909,826	9,161,708	4,866,082
Gross profit	200,064	2,032,504	637,718
Costs and Expenses:			
Research and development	5,106,379	6,676,716	5,048,917
Sales and marketing	6,837,544	6,764,832	3,429,443
General and administrative	4,018,339	2,283,817	2,226,012
Total costs and expenses	15,962,262	15,725,365	10,704,372
Operating Loss	(15,762,198)	(13,692,861)	(10,066,654)
Interest Income, net	1,746,428	2,056,014	1,832,798
Litigation Settlement Expense (Note 5)	-	(3,376,144)	-
Net Loss	\$(14,015,770)	\$(15,012,991)	\$(8,233,856)
Basic and Diluted Net Loss Per Common Share	\$ (1.24)	\$ (1.44)	\$ (.90)
Basic and Diluted Weighted Average Number of Common Shares Outstanding (Note 2)	11,346,148	10,428,520	9,173,419
The accompanying notes to financial statements are an integral part of these statements.			

Statements of Shareholders' Equity

	Common Stock		Additional Paid-In Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
	Shares	Amount				
Balance , June 30, 1996	9,128,433	\$ 91,284	\$ 59,030,559	\$ (18,533,506)	\$ —	\$ 40,588,337
Change in unrealized losses						
on investment	—	—	—	—	(59,258)	(59,258)
Net loss	—	—	—	(8,233,856)	—	(8,233,856)
Comprehensive loss	—	—	—	—	—	(8,293,114)
Stock options exercised	128,161	1,282	100,538	—	—	101,820
Balance , June 30, 1997	9,256,594	92,566	59,131,097	(26,767,362)	(59,258)	32,397,043
Change in unrealized losses						
on investment	—	—	—	—	47,750	47,750
Net loss	—	—	—	(15,012,991)	—	(15,012,991)
Comprehensive loss	—	—	—	—	—	(14,965,241)
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
Balance , June 30, 1998	11,239,892	112,399	91,016,366	(41,780,353)	(11,508)	49,336,904
Change in unrealized losses						
on investment	—	—	—	—	10,127	10,127
Net loss	—	—	—	(14,015,770)	—	(14,015,770)
Comprehensive loss	—	—	—	—	—	(14,005,643)
Stock options exercised	159,224	1,592	68,986	—	—	70,578
Stock awards net of related amortization	29,821	298	64,506	—	—	64,804
Balance , June 30, 1999	11,428,937	\$114,289	\$91,149,858	\$(55,796,123)	\$ (1,381)	\$35,466,643

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

Statements of Cash Flows

For the Years Ended June 30	1999	1998	1997
Operating Activities:			
Net loss	\$(14,015,770)	\$(15,012,991)	\$ (8,233,856)
Adjustments to reconcile net loss to net cash used for operating activities –			
Depreciation and amortization	1,469,355	1,619,940	431,223
Loss on disposal of assets	773,191	–	–
Change in operating items:			
Accounts receivable	2,752,723	(2,194,522)	(1,703,453)
Inventories	1,877,477	(2,740,539)	(1,237,928)
Prepays and other assets	155,609	29,278	(301,617)
Accounts payable and accrued liabilities	(605,104)	987,058	1,424,064
Net cash used for operating activities	(7,592,519)	(17,311,776)	(9,621,567)
Investing Activities:			
Purchases of property and equipment	(990,867)	(2,222,112)	(1,901,246)
Purchase of securities	(37,535,450)	(57,164,738)	(83,807,022)
Proceeds from sale of securities	45,783,611	47,421,001	98,701,702
Purchase of intangible assets, net	–	(2,000,000)	(3,244,620)
Net cash provided by (used for) investing activities	7,257,294	(13,965,849)	9,748,814
Financing Activities:			
Proceeds from issuance of common stock, net	135,382	31,905,102	101,820
Payments made on capital lease obligations	(25,362)	(20,247)	(18,538)
Net cash provided by financing activities	110,020	31,884,855	83,282
Net Increase (Decrease) In Cash and Cash Equivalents	(225,205)	607,230	210,529
Cash and Cash Equivalents:			
Beginning of year	882,801	275,571	65,042
End of year	\$ 657,596	\$ 882,801	\$ 275,571
Supplemental Cash Flow Disclosures:			
Cash paid for interest	\$ 3,346	\$ 5,863	\$ 8,706

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 urological disorders. 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 U.S. 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 comprehensive income in the statement of shareholders' equity.

Inventories

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

June 30	1999	1998
Raw materials	\$ 783,091	\$2,349,717
Work-in-process	1,180,443	132,559
Finished goods	472,884	1,831,619
	\$2,436,418	\$4,313,895

Recently Issued Accounting Standards

The Company adopted Statement of Financial Accounting Standards (SFAS) No. 130, "Reporting Comprehensive Income." SFAS No. 130 establishes standards for reporting comprehensive income in the financial statements. Comprehensive income includes all changes in equity during a period except those resulting from investments by and distributions to owners. For the Company, comprehensive income represents net income adjusted for unrealized gains/losses on available-for-sale securities.

The Company adopted the provisions of SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information." SFAS No. 131 establishes new accounting standards for segment reporting. No operational segment or customer information is required for the Company.

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. Ultimate results could differ from those estimates.

Financial Instruments

Management believes that the carrying amount of the Company's financial instruments, including cash, available-for-sale securities, accounts payable and accruals, approximates fair value as the majority of these instruments are short-term in nature.

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:

	1999	1998	1997
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, 1999, the Company had net operating loss carryforwards of approximately \$55,000,000 for federal income tax purposes that are available to offset future taxable income through the year 2014. 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 assets for the years ended June 30 is as follows:

	1999	1998	1997
Net operating loss carryforwards	\$ 22,082,000	\$ 16,762,000	\$ 10,151,000
Temporary deductible differences	720,000	228,000	160,000
Valuation allowance	(22,802,000)	(16,990,000)	(10,311,000)
	\$ -	\$ -	\$ -

4. Shareholders' Equity:

Secondary Public Offering

In November 1997, the Company completed a secondary public offering of 1,725,000 shares of common stock, which 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.

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, 1999, the Company has reserved 2,450,910 shares of common stock under this plan. As of June 30, 1999, 821,798 shares were available for future grants under this plan. Options expire seven to 10 years from the date of grant and are subject to varying vesting schedules. Under the current terms of the Company's 1991 Stock Option Plan, persons serving as non-employee directors at the date of the annual shareholder meeting automatically receive a grant to purchase 5,000 shares of common stock at a price equal to fair market value on the date of grant. The options are immediately exercisable on the date of grant and expire 10 years from the date of grant, subject to earlier termination one year after the person ceases to be a director of the Company. In May 1998 and October 1998, the Company repriced certain stock options previously granted to \$8.81 and then to \$3.65, the fair market value on the date of repricing.

Shares subject to option are summarized as follows:

	Stock Options	Weighted Average Exercise Price
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	(159,635)	8.27
Options exercised	(240,562)	1.19
Balance at June 30, 1998	1,020,774	8.23
Options granted	1,359,421	3.69
Options canceled	(939,585)	8.64
Options exercised	(159,224)	.44
Balance at June 30, 1999	1,281,386	\$ 3.81
Options exercisable at June 30, 1999	270,839	\$ 4.07

The Company accounts for stock options under the provisions of 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 net loss and loss per share would have been increased to the following pro forma amounts:

	1999	1998	1997
Net loss:			
As reported	\$(14,015,770)	\$(15,012,991)	\$(8,233,856)
Pro forma	(15,850,908)	(16,942,225)	(9,872,331)
Net loss per share:			
As reported	\$ (1.24)	\$ (1.44)	\$ (.90)
Pro forma	(1.40)	(1.63)	(1.08)

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 1999, 1998 and 1997, respectively: risk-free interest rates of 6.16%, 5.52% and 6.87%, no expected dividend yield, expected volatility of 70.83% in 1999 and 54.25% in 1998 and 1997, and expected lives of seven years.

The weighted average fair value of options granted during 1999, 1998 and 1997 was \$2.62, \$10.51 and \$16.35, respectively. Options outstanding at June 30, 1999 have an exercise price between \$0.40 and \$14.00, a weighted average exercise price of \$4.07 and a weighted average remaining contractual life of 8.6 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' 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, 1999, 22,557 shares had been purchased under the Plan for gross proceeds of \$187,394.

5. Commitments and Contingencies:

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, outside Japan and the United States.

Litigation

In May 1998, the Company entered into a settlement agreement resolving litigation with BSD Medical Corporation (BSD) and TherMatrx, Inc. (TherMatrx) regarding a dispute about a previous settlement agreement. Pursuant to the settlement agreement, the Company paid \$5 million to BSD and TherMatrx and will maintain its non-exclusive license to certain patents owned by BSD and TherMatrx 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 is amortized against future sales, and the remaining \$3 million plus related legal expenses were recorded as 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 of up to 15% of their 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 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, 1999, 1998 and 1997, respectively. Future minimum lease commitments under noncancelable operating leases with initial remaining terms of one year or more are as follows as of June 30, 1999:

	Operating Leases
Fiscal year:	
2000	\$ 280,409
2001	280,409
2002	296,763
2003	205,632
	\$1,063,213

Report of Independent Public Accountants

To Urologix, Inc.:

We have audited the accompanying balance sheets of Urologix, Inc. (a Minnesota corporation) as of June 30, 1999 and 1998, and the related statements of operations, shareholders' equity and cash flows for each of the three fiscal years in the period ended June 30, 1999. 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, 1999 and 1998, and the results of its operations and its cash flows for each of the three fiscal years in the period ended June 30, 1999, in conformity with generally accepted accounting principles.

ARTHUR ANDERSEN LLP

Minneapolis, Minnesota,
July 23, 1999