# Spectral Diagnostics Inc.

Condensed Interim Financial Statements

**September 30, 2014**
(Unaudited)

These unaudited condensed interim financial statements have been prepared by management of Spectral Diagnostics Inc. and have not been reviewed by the Company's auditor.

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# Spectral Diagnostics Inc.

Condensed Interim Statement of Financial Position

(in thousands of Canadian dollars)

| | September 30 2014 $ | December 31 2013 $ |
|---|---|---|
| | Unaudited | Audited |
| **Assets** | | |
| **Current assets** | | |
| Cash and cash equivalents | 11,700 | 7,229 |
| Trade and other receivables | 610 | 569 |
| Inventories | 179 | 315 |
| Prepayments | 389 | 289 |
| | 12,878 | 8,402 |
| **Non-current assets** | | |
| Property, plant and equipment | 520 | 627 |
| Intangible asset | 391 | 409 |
| | 911 | 1,036 |
| **Total assets** | 13,789 | 9,438 |
| **Liabilities** | | |
| **Current liabilities** | | |
| Trade and other payables | 2,532 | 3,636 |
| Deferred revenue | 27 | 106 |
| **Total liabilities** | 2,559 | 3,742 |
| **Equity** | | |
| Share capital | 46,879 | 33,957 |
| Contributed surplus | 8,413 | 3,864 |
| Other equity reserves | 3,534 | 7,833 |
| Deficit | (47,596) | (39,958) |
| **Total equity** | 11,230 | 5,696 |
| **Total liabilities and equity** | 13,789 | 9,438 |

**Approved by the Board of Directors**

**(signed) Anthony Bihl III** Director **(signed) Guillermo Herrera** Director

The accompanying notes are an integral part of these unaudited condensed interim financial statements.

# Spectral Diagnostics Inc.

Condensed Interim Statement of Loss and Comprehensive Loss
For the nine months ended September, 2014 and 2013
(Unaudited)

(in thousands of Canadian dollars, except for share and per share data)

| | Note | Three months ended September 30 | | Nine months ended September 30 | |
|---|---|---|---|---|---|
| | | 2014 $ | 2013 $ | 2014 $ | 2013 $ |
| **Revenue** | | 643 | 679 | 2,265 | 1,959 |
| Other income | | 13 | 5 | 27 | 24 |
| **Expenses** | | | | | |
| Changes in inventories of finished goods and work- in-process | | 30 | 114 | 230 | 235 |
| Raw materials and consumables used | | 104 | 133 | 315 | 414 |
| Employee benefits | 8, 10 | 840 | 719 | 2,709 | 2,173 |
| Consulting and professional fees | | 1,310 | 1,793 | 5,200 | 4,971 |
| Management services | | - | - | - | 275 |
| Regulatory and investor relations | | 51 | 48 | 185 | 179 |
| Travel and entertainment | | 162 | 228 | 726 | 898 |
| Depreciation and amortization | | 49 | 62 | 172 | 176 |
| Foreign exchange (gain)loss | | 2 | 4 | 49 | 4 |
| Other expenses | | 120 | 116 | 344 | 366 |
| | | 2,668 | 3,217 | 9,930 | 9,691 |
| **Operating loss** | | (2,012) | (2,533) | (7,638) | (7,708) |
| Finance income | | - | 16 | - | 49 |
| **Loss and comprehensive loss for the period** | | (2,012) | (2,517) | (7,638) | (7,659) |
| **Basic and diluted loss per common share** | | (0.01) | (0.02) | (0.05) | (0.06) |
| **Weighted average number of common shares outstanding** | | 168,846,613 | 132,669,898 | 146,049,893 | 126,299,847 |

The accompanying notes are an integral part of these unaudited condensed interim financial statements.

# Spectral Diagnostics Inc.

Condensed Interim Statement of Changes in Equity
(Unaudited)

(in thousands of Canadian dollars, except number of shares)

| | Note | Issued capital Number | $ | Contributed surplus $ | Share-based compensation $ | Warrants $ | Deficit $ | Total equity $ |
|---|---|---|---|---|---|---|---|---|
| **Balance, January 1, 2013** | | 113,883,394 | 27,101 | 3,864 | 3,117 | 5,143 | (28,651) | 10,574 |
| Private placement | 12 | 18,666,667 | 5,480 | - | - | - | - | 5,480 |
| Share options exercised | | 450,000 | 242 | | (106) | | | 136 |
| Loss and comprehensive loss for the period | | - | - | - | - | - | (7,659) | (7,659) |
| Share-based compensation | 8, 10 | - | - | - | 169 | - | - | 169 |
| **Balance, September 30, 2013** | | 133,000,061 | 32,823 | 3,864 | 3,180 | 5,143 | (36,310) | 8,700 |
| | | | | | | | | |
| **Balance, January 1, 2014** | | 134,462,561 | 33,957 | 3,864 | 3,239 | 4,594 | (39,958) | 5,696 |
| Private placement | 12 | 45,051,186 | 12,816 | - | - | - | - | 12,816 |
| Share options exercised | | 222,500 | 105 | (45) | - | - | - | 60 |
| Warrants exercised | | 994 | 1 | - | - | - | - | 1 |
| Warrants expired | | - | - | 4,594 | - | (4,594) | - | - |
| Loss and comprehensive loss for the period | | - | - | - | - | - | (7,638) | (7,638) |
| Share-based compensation | 8, 10 | - | - | - | 295 | - | - | 295 |
| **Balance, September 30, 2014** | | 179,737,241 | 46,879 | 8,413 | 3,534 | - | (47,596) | 11,230 |

The accompanying notes are an integral part of these unaudited condensed interim financial statements.

# Spectral Diagnostics Inc.

Condensed Interim Statement of Cash Flows
For the nine months ended September 30, 2014 and 2013
(Unaudited)

(in thousands of Canadian dollars)

| | Note | Nine months ended September 30 2014 $ | Nine months ended September 30 2013 $ |
|---|---|---|---|
| **Cash flow provided by (used in)** | | | |
| **Operating activities** | | | |
| Loss and comprehensive loss for the period | | (7,638) | (7,659) |
| Adjustments for: | | | |
| Depreciation on property, plant, and equipment | | 154 | 158 |
| Amortization of intangible assets | | 18 | 18 |
| Share-based compensation | 8, 10 | 295 | 169 |
| Changes in items of working capital: | | | |
| Trade and other receivables | | (41) | 80 |
| Inventories | | 136 | (80) |
| Prepayments | | (100) | (79) |
| Trade and other payables | | (1,104) | 614 |
| Deferred revenue | | (79) | (74) |
| **Net cash used in operating activities** | | (8,359) | (6,853) |
| **Investing activities** | | | |
| Property, plant and equipment expenditures | | (47) | (281) |
| Redemption of short-term investment | | - | 5,137 |
| Purchase of short-term investment | | - | (5,189) |
| **Net cash used in investing activities** | | (47) | (333) |
| **Financing activities** | | | |
| Private placement | 12 | 12,816 | 5,480 |
| Share options exercised | | 60 | 136 |
| Warrants exercised | | 1 | - |
| **Net cash provided by financing activities** | | 12,877 | 5,616 |
| Increase(decrease) in cash and cash equivalents | | 4,471 | (1,570) |
| Cash and cash equivalents, beginning of period | | 7,229 | 5,425 |
| **Cash and cash equivalents, end of period** | | 11,700 | 3,855 |

The accompanying notes are an integral part of these unaudited condensed interim financial statements.

(in thousands of Canadian dollars, except for share and per share data)

## 1. Nature of operations

Spectral Diagnostics Inc. (Spectral or the Company) was incorporated on July 29, 1991 in Ontario, Canada. The Company is strategically focused on the development and commercialization of a treatment for severe sepsis utilizing its Endotoxin Activity Assay (EAA™) diagnostic and the Toraymyxin™ therapeutic. The address of the registered office is 135-2 The West Mall, Toronto, Ontario.

## 2. Basis of preparation

These condensed interim financial statements of Spectral Diagnostics Inc. for the nine months ended September 30, 2014 have been prepared in accordance with Canadian Generally Accepted Accounting Principles ("Canadian GAAP"), defined as International Financial Reporting Standards ("IFRS") as set out in the Handbook of the Canadian Institute of Chartered Accountants applicable to the preparation of interim financial statements, including IAS 34, "Interim Financial Reporting". The condensed interim financial statements should be read in conjunction with the annual financial statements for the year ended December 31, 2013, which have been prepared in accordance with Canadian GAAP. These condensed interim financial statements were approved by the Board of Directors for issue on November 12, 2014.

## 3. Significant accounting policies

The significant accounting polices used in the preparation of these condensed interim financial statements are consistent with those of the previous financial year.

## 4. Estimates

The preparation of condensed interim financial statements in accordance with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise judgment in applying Spectral's accounting policies. The areas involving a higher degree of judgment or complexity, or areas where assumptions are significant to the financials are the same as those that were applied to the financial statements for the year ended December 31, 2013.

## 5. Accounting standards issued but not yet applied

There are no new IFRSs or IFRICs that are effective for the first time for this interim period that would be expected to have a material impact on the Company.

(in thousands of Canadian dollars, except for share and per share data)

## 6. Risk management

### *i. Financial risk management*

In the normal course of business, the Company is exposed to a number of financial risks that can affect its operating performance. These risks are: credit risk, liquidity risk and market risk. The Company's overall risk management program and prudent business practices seek to minimize any potential adverse effects on the Company's financial performance.

The condensed interim financial statements do not include all financial risk management information and disclosures required in the annual financial statements. They should be read in conjunction with the annual financial statement as at December 31, 2013. There have been no changes in the risk management since year end or in any risk management policies.

### *ii. Liquidity risk*

Liquidity risk is the risk that the Company will encounter difficulty in meeting obligations associated with its financial liabilities. The Company is exposed to liquidity risk, as it continues to have net cash outflows to support its operations. The company's objective for liquidity risk management is to maintain sufficient liquid financial resources to fund the statement of financial position and to meet commitments and obligations in the most cost effective manner possible.

The Company achieves this by maintaining sufficient cash and cash equivalents and managing working capital. The Company monitors its financial resources on a weekly basis and updates its expected use of cash resources on the latest available data. All of the Company's financial liabilities are classified as current liabilities. Current liabilities were $2,559 as at September 30, 2014 with all of it having expected settlement dates within one year. There are uncertainties related to the timing and use of the Company's cash resources.

## 7. Commitments

The Company is potentially committed to future expenditures for its EUPHRATES trial.

These commitments are based on enrolment of up to 605 patients at up to 60 clinical sites in the U.S. and Canada and are dependent on the rate of patient enrolment and the duration of the trial. The Company is only committed to the costs to the extent that patients are enrolled in the trial.

(in thousands of Canadian dollars, except for share and per share data)

Current estimates of future commitments for the trial are:

| | 2014<br>$ | 2015<br>$ | 2016<br>$ | 2017<br>$ |
|---|---|---|---|---|
| Program management | 755 | 3,191 | 2,878 | 1,787 |
| Program oversight | 54 | 147 | 88 | 104 |
| Clinical site costs | 616 | 2,700 | 2,785 | - |
| Diagnostic supply and training | 77 | 265 | 265 | - |
| Employee benefits | 318 | 545 | 545 | 273 |
| Consultants | 41 | 54 | 54 | - |
| | **1,861** | **6,902** | **6,615** | **2,164** |

## 8. Share capital

The Company granted the following share options to its directors and officers, at the discretion of the Board of Directors.

| September 30, 2014 | | | September 30, 2013 | | |
|---|---|---|---|---|---|
| Date | Number of share options | Exercise price | Date | Number of share options | Exercise price |
| January 3, 2014 | 916,000 | $0.60 | February 7, 2013 | 950,000 | $0.21 |
| | | | May 1, 2013 | 100,000 | $0.20 |
| | | | August 12, 2013 | 550,000 | $0.38 |

The exercise prices of the share options are equal to the closing market price of the Company's shares on the Toronto Stock Exchange on the immediately preceding day of the grant of the options. Share options issued to the Company's directors vest 100% at the time of the grant. Share options issued to the Company's officers vest at 25% of the grant amount at the time of the grant. The balance of these share options vest equally in each successive quarter and will be fully vested by the end of the third year following the grant date. Share options issued in 2014 vest January 3, 2017. Share options issued in 2013 will be fully vested by February 7, 2016, May 1, 2016 and August 12, 2016 respectively. The contractual life of each share option is five years. There is no cash settlement of the share options.

The volatility measured at the standard deviation of continuously compounded share returns is based on statistical analysis of weekly share prices over the last five years.

(in thousands of Canadian dollars, except for share and per share data)

Share options granted were valued using the Black-Scholes option pricing model, with the following assumptions:

| | September 30, 2014 | | September 30, 2013 | |
|---|---|---|---|---|
| Grant date | January 3 2014 | August 12 2013 | May 1 2013 | February 7 2013 |
| Risk-free interest rate | 1.95% | 1.89% | 1.15% | 1.48% |
| Expected life | 5 years | 5 years | 5 years | 5 years |
| Annualized volatility | 74.89% | 83.40% | 84.88% | 85.99% |
| Dividend rate | 0% | 0% | 0% | 0% |
| Grant date share price | $0.580 | $0.375 | $0.200 | $0.215 |
| Share option fair value | $0.354 | $0.253 | $0.133 | $0.146 |

## 9. The EUPHRATES trial

The Company's current clinical development program is focused on obtaining U.S. FDA approval for Toraymyxin, a therapeutic device for the treatment of sepsis that removes endotoxin from the bloodstream.

The Company has incurred the following costs associated with this clinical trial:

| | Three months ended September 30 | | Nine months ended September 30 | |
|---|---|---|---|---|
| | **2014** | **2013** | **2014** | **2013** |
| | **$** | **$** | **$** | **$** |
| Program management | 725 | 780 | 2,622 | 2,628 |
| Program oversight | 74 | 63 | 197 | 182 |
| Clinical site costs | 475 | 873 | 1,975 | 2,133 |
| Diagnostic supply and training | 29 | 106 | 150 | 363 |
| Employee benefits | 128 | 113 | 355 | 331 |
| Consultants | 27 | 54 | 135 | 182 |
| **Total EUPHRATES** | **1,458** | **1,989** | **5,434** | **5,819** |

The trial costs have been included in the statement of loss and comprehensive loss where applicable. Total trial costs since inception in 2010 are $24,269.

(in thousands of Canadian dollars, except for share and per share data)

## 10. Employee benefits

Key management includes the Company's directors and officers. Compensation awarded to key management included:

| | Three months ended September 30, 2014 | | Nine months ended September 30, 2014 | |
|---|---|---|---|---|
| | | $ | | $ |
| | All employees | Key management | All employees | Key management |
| Salaries | 580 | 288 | 1,659 | 839 |
| Bonuses | 90 | 90 | 270 | 270 |
| Short term employee benefits | 68 | 19 | 222 | 65 |
| Directors fees | 61 | 61 | 182 | 182 |
| Post-employment benefits | - | - | 42 | 42 |
| Share- based compensation | 38 | 32 | 295 | 264 |
| Other | 3 | - | 39 | 32 |
| | **840** | **490** | **2,709** | **1,694** |

| | Three months ended September 30 2013 | | Nine months ended September 30 2013 | |
|---|---|---|---|---|
| | | $ | | $ |
| | All employees | Key management | All employees | Key management |
| Salaries | 531 | 282 | 1,558 | 809 |
| Short term employee benefits | 71 | 22 | 212 | 70 |
| Directors fees | 51 | 51 | 173 | 173 |
| Post-employment benefits | - | - | 42 | 42 |
| Share- based compensation | 63 | 28 | 169 | 129 |
| Other | 3 | 1 | 19 | 13 |
| | **719** | **384** | **2,173** | **1,236** |

## 11. Related party transactions

i. Toray Industries, Inc. ( "Toray")

Toray holds 33,731,513 Spectral shares, representing approximately 18.8% (2013 – 12.5%) of Spectral's issued and outstanding capital, calculated on a non-diluted basis.

Toray is entitled to nominate one director (the "Toray Representative") to the Board of Directors as long as it owns in the aggregate not less than 10% of the common shares issued and outstanding calculated on a non-diluted basis. Mr. Koichiro Takeshita is the Toray representative.

(in thousands of Canadian dollars, except for share and per share data)

The principal transactions with Toray which were carried out in the ordinary course of business are:

| | Three months ended September 30 | | Nine months ended September 30 | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | | $ | | $ |
| **Revenue** | | | | |
| Toray Medical Co., Ltd. | 45 | 27 | 135 | 102 |
| Toray International Italy S.r.l. | - | - | - | 73 |
| Toray Industries, Inc. | 12 | - | 12 | - |
| **Purchases** | | | | |
| Toray Industries, Inc. | - | - | 36 | - |
| | | | | |
| **Due from(to) related party** | | | | |
| Toray Medical Co., Ltd. | | | - | - |
| Toray International Italy S.r.l. | | | - | - |
| Toray Industries, Inc. | - | - | (24) | - |

ii. Birch Hill Equity Partners Management Inc.("Birch Hill")

Birch Hill, through a number of funds, holds 25,402,913 common shares of the Company representing approximately a 14.1% ownership interest.
Birch Hill is entitled to nominate one director to the Company's Board so long as it owns in aggregate not less than 5% of the issued and outstanding common shares of the Company calculated on a non-diluted basis.

iv. Key management consists of the Company's four executive officers and its Board of Directors. Compensation of key management is disclosed in Note 10.

There are no other related party transactions.

## 12. Private placements

i. On July 11, 2014, the Company entered into agreements for a non-brokered private placement of up to $18,200 (the "Offering"), comprised of a Tranche "A" component and a Tranche "B" component.

The Tranche "A" component of the private placement, in the amount of $13,200, was completed on July 25, 2014. The Company received net proceeds of $12,816 which will be used to fund its EUPHRATES trial and for working capital and general corporate purposes.

The Tranche "A" component is comprised of 45,051,086 common shares ("Shares") of the Company at a subscription price of $0.293 per Share (representing the 20 day volume weighted

(in thousands of Canadian dollars, except for share and per share data)

average trading price of the Shares on the TSX for the 20 day period ending June 6, 2014, for aggregate gross proceeds of $13,200, of which (a) 17,064,846 Shares, for aggregate proceeds of $5,000, were sold to Toray Industries, Inc.; (b) 18,259,382 Shares, for aggregate proceeds of $5,350 were sold to other insiders; and (c) 9,726,958 Shares for aggregate proceeds of $2,850, were sold to other investors.

The Tranche "B" component of the Offering is comprised of additional Shares to be sold to Toray by the Company of up to $5,000, if, as and when the Company exercises the right (the "Call Right"), granted by Toray to the Company. The Call Right is exercisable by written notice given by the Company to Toray at any time on or after March 1, 2015 until March 15, 2015, to require Toray to purchase from the Company , at a subsequent closing to occur on April 1, 2015, up to that number of Shares as is determined by dividing the Call Right amount exercised (up to the $5,000), as applicable, by the volume weighted average trading price of the Shares on the TSX for the twenty trading days ending on the business day prior to the day the Call Right is exercised. The Shares to be sold to Toray in Tranche"B" will only be sold if the Company exercises the Call Right.

ii. On April 2, 2013, the Company completed a private placement financing, whereby the Company issued 18,666,667 common shares in the capital of the Company ("Common Shares"), at a price of $0.30 per Common Share, to three investors for aggregate gross proceeds of $5,600 ("the Private Placement"). The Company received net proceeds of $5,480 which was used to continue to support the Company's EUPHRATES clinical trial and for general corporate purposes.

As part of the Private Placement, Toray Industries, Inc. ("Toray") acquired 16,666,667 Common Shares at a price of $0.30 per Common Share, for $5,000.