# Spectral Medical Inc.

Condensed Interim Financial Statements

**March 31, 2015**
(Unaudited)

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

# Spectral Medical Inc.

**Condensed Interim Financial Statements**
March 31, 2015

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# Spectral Medical Inc.

Condensed Interim Statements of Financial Position

(in thousands of Canadian dollars)

| | Notes | March 31 2015 $ | December 31 2014 $ |
|---|---|---|---|
| **Assets** | | | |
| **Current assets** | | | |
| Cash and cash equivalents | | 7,068 | 10,054 |
| Trade and other receivables | | 675 | 583 |
| Inventories | | 218 | 166 |
| Prepayments | | 234 | 185 |
| | | 8,195 | 10,988 |
| **Non-current assets** | | | |
| Property and equipment | | 571 | 490 |
| Intangible asset | | 378 | 384 |
| | | 949 | 874 |
| **Total assets** | | 9,144 | 11,862 |
| **Liabilities** | | | |
| **Current liabilities** | | | |
| Trade and other payables | | 2,411 | 2.893 |
| Deferred revenue | | 85 | 149 |
| **Total liabilities** | | 2,496 | 3,042 |
| **Equity** | | | |
| Share capital | 8,11 | 46,931 | 46,879 |
| Contributed surplus | | 7,826 | 7,849 |
| Other equity reserves | 8 | 3,606 | 3,542 |
| Deficit | | (51,715) | (49,450) |
| **Total equity** | | 6,648 | 8,820 |
| **Total liabilities and equity** | | 9,144 | 11,862 |

Contingencies and Commitments (Note 7)

# Spectral Medical Inc.

Condensed Interim Statements of Loss and Comprehensive Loss
For the three months ended March 31, 2015 and 2014
(Unaudited)

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

| | Notes | 2015<br>$ | 2014<br>$ |
|---|---|---|---|
| **Revenue** | | 877 | 844 |
| **Expenses** | | | |
| Changes in inventories of finished goods and work- in-process | | 24 | 173 |
| Raw materials and consumables used | | 100 | 77 |
| Employee benefits | 8,10 | 947 | 1,034 |
| Consulting and professional fees | | 1,572 | 2,287 |
| Regulatory and investor relations | | 170 | 76 |
| Travel and entertainment | | 203 | 179 |
| Depreciation and amortization | | 43 | 64 |
| Foreign exchange (gain) loss | | (17) | 27 |
| Other expenses | | 124 | 116 |
| | | 3,166 | 4,033 |
| **Operating loss** | | (2,289) | (3,189) |
| Finance income | | 24 | 14 |
| **Loss and comprehensive loss for the period** | | (2,265) | (3,175) |
| **Basic and diluted loss per common share** | 8 | (0.01) | (0.02) |
| **Weighted average number of common shares outstanding** | 8 | 179,750,247 | 134,462,580 |

# Spectral Medical Inc.

Condensed Interim Statements of Changes in Equity
For the three months ended March 31, 2015 and 2014
(Unaudited)

(in thousands of Canadian dollars)

| | Notes | Issued capital Number | $ | Contributed surplus $ | Share-based compensation $ | Warrants $ | Deficit $ | Total Equity $ |
|---|---|---|---|---|---|---|---|---|
| **Balance, January 1, 2014** | | 134,462,561 | 33,957 | 3,864 | 3,239 | 4,594 | (39,958) | 5,696 |
| Warrants exercised | 8 | 46 | - | - | - | - | - | - |
| Loss and comprehensive loss for the period | | - | - | - | - | - | (3,175) | (3,175) |
| Share-based compensation | 8,10 | - | - | - | 205 | - | - | 205 |
| **Balance, March 31, 2014** | | 134,462,607 | 33,957 | 3,864 | 3.444 | 4,594 | (43,133) | 2,726 |
| | | | | | | | | |
| **Balance, January 1, 2015** | | 179,737,241 | 46,879 | 7,849 | 3,542 | - | (49,450) | 8,820 |
| Shares repurchased under the normal course issuer bid | 8 | (90,000) | (32) | (23) | - | - | - | (55) |
| Share options exercised | 8 | 108,500 | 84 | - | (41) | - | - | 43 |
| Loss and comprehensive loss for the period | | - | - | - | - | - | (2,265) | (2,265) |
| Share-based compensation | 8,10 | - | - | - | 105 | - | - | 105 |
| **Balance, March 31, 2015** | | 179,755,741 | 46,931 | 7,826 | 3,606 | - | (51,715) | 6,648 |

# Spectral Medical Inc.

Condensed Interim Statements of Cash Flows
For the three months ended March 31, 2015 and 2014
(Unaudited)

(in thousands of Canadian dollars)

| | Notes | 2015<br>$ | 2014<br>$ |
|---|---|---|---|
| **Cash flow provided by (used in)** | | | |
| **Operating activities** | | | |
| Loss and comprehensive loss for the year | | (2,265) | (3,175) |
| Adjustments for: | | | |
| Depreciation on property and equipment | | 37 | 58 |
| Amortization of intangible asset | | 6 | 6 |
| Share-based compensation | 8,10 | 105 | 205 |
| Changes in items of working capital: | | | |
| Trade and other receivables | | (92) | (104) |
| Inventories | | (52) | 126 |
| Prepayments | | (49) | (54) |
| Trade and other payables | | (482) | (533) |
| Deferred revenue | | (64) | (26) |
| **Net cash used in operating activities** | | (2,856) | (3,497) |
| **Investing activities** | | | |
| Property and equipment expenditures | | (118) | (2) |
| **Net cash used in investing activities** | | (118) | (2) |
| **Financing activities** | | | |
| Share options exercised | 8 | 43 | - |
| Shares repurchased under the NCIB | 8 | (55) | - |
| **Net cash used in financing activities** | | (12) | - |
| Decrease in cash and cash equivalents | | (2,986) | (3,499) |
| Cash and cash equivalents, beginning of period | | 10,054 | 7,229 |
| **Cash and cash equivalents, end of period** | | 7,068 | 3,730 |

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

## 1. Nature of operations

Spectral Medical Inc. (Spectral or the Company) was incorporated on July 29, 1991 in Ontario, Canada as Spectral Diagnostics Inc. Effective December 31, 2014, the Company's name was changed to "Spectral Medical Inc.". The address of the registered office is 135 The West Mall, Unit 2, Toronto, Ontario.

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 Company also manufactures and sells certain proprietary reagents.

## 2. Basis of preparation

The condensed interim financial statements of Spectral for the three months ended March 31, 2015, have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB") as set out in the CPA Canada Handbook 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, 2014, which have been prepared in accordance with IFRS. These condensed interim financial statements were approved by the Board of Directors for issue on May 12, 2015.

## 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. Critical accounting estimates and judgments

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, 2014.

## 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 materially affect 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. 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 statement. They should be read in conjunction with the annual financial statements as at December 31, 2014. There have been no changes in the risk management or in any risk management policies since year end.

### *ii. Liquidity risk*

Liquidity risk is the risk that the Company will encounter difficulty in meeting obligations associated with its financial liabilities as they become due. 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 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 $2,496 as at March 31, 2015 with all of them having expected settlement dates within one year. There are uncertainties related to the timing and use of the Company's cash resources.

## 7. Contingencies and commitments

i. The Company has committed to expenditures for its EUPHRATES trial as follows:

| | 2015<br>$ | 2016<br>$ | 2017<br>$ |
|---|---|---|---|
| Program management | 2,147 | 2,970 | 2,927 |
| Program oversight | 129 | 117 | 176 |
| Clinical site costs | 1,454 | 2,125 | 1,980 |
| Diagnostic supply and training | 226 | 277 | 277 |
| Employee benefits | 396 | 490 | 490 |
| Consultants | 41 | 54 | 54 |
| | **4,393** | **6,033** | **5,904** |

Future commitments for the trial are based on enrolment of 605 evaluable patients in accordance with the approved clinical protocol at up to 60 clinical sites in the U.S. and Canada. These commitments are subject to change dependent on the final required sample

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

size of the trial. The Company is only committed to the costs to the extent that evaluable patients are enrolled.

ii. Directors and officers are indemnified by the Company for various items including, but not limited to, costs to settle lawsuits or actions due to their association with the Company, subject to certain restrictions. The Company has purchased directors' and officers' liability insurance to mitigate the costs of any potential future lawsuits or actions. The term of the indemnification covers the period during which the indemnified party served as a director or officer of the Company.

In the normal course of business, the Company has entered into agreements that include indemnities in favour of third parties, such a purchase and sale agreements, confidentiality agreements, engagement letters with advisors and consultants, leasing contracts and licence agreements. These indemnification arrangements may sometimes require such third parties to compensate counter parties for losses as a result of breaches in representations, covenants and warranties provided by the Company or as a result of litigation or other third party claims or statutory sanctions that may be suffered by the counterparties as a consequence of the relevant transaction. In some instances, the terms of these indemnities are not explicitly defined.

## 8. Share capital

i. The Company is authorized to issue an unlimited number of common shares.

ii. On December 15, 2014, the Company announced that the Toronto Stock Exchange (the TSX") approved its notice of intention to make a normal course issuer bid ("NCIB") for its outstanding common shares (the "Shares"). Pursuant to the notice, the Company may purchase up to 3,594,745 of its Shares, representing approximately 2% of its issued and outstanding Shares, during the twelve month period commencing December 17, 2014 and ending December 16, 2015.

At the time of acceptance, there were 179,737,241 Shares issued and outstanding. The Company may purchase up to 22,461 Shares on the TSX during any trading day, which represents approximately 25% of the average daily trading volume on the TSX for the most recently completed six calendar months prior to the TSX's acceptance of the notice of the NCIB. All Shares purchased under the issuer bid will be cancelled.

The Company repurchased 90,000 Shares under this NCIB for $55 as of March 31, 2015.

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

iii. Details of share options are as follows:

| | March 31, 2015 | | | March 31, 2014 | |
|---|---|---|---|---|---|
| Date | Number of share options | Exercise price | Date | Number of share options | Exercise price |
| January 22, 2015 | 1,250,000 | $0.38 | January 3, 2014 | 916,000 | $0.60 |
| March 24, 2015 | 100,000 | $0.67 | | | |

The exercise prices of the share options are equal to the closing market price of the Company's shares on the TSX on the immediately preceding day of the grant of the option. Share options issued to the Company's directors vest 100% at the time of the grant. Share options issued to the Company's officers, employees, and others generally 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 on January 22, 2015, will be fully vested by January 22, 2020. The share options issued March 24, 2015, will be fully vested by December 31, 2015. 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.

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

| | 2015 | | 2014 |
|---|---|---|---|
| Grant date | March 24 2015 | January 22 2015 | January 3 2014 |
| Risk-free interest rate | 0.72% | 1.95% | 1.95% |
| Expected life | 5 years | 5 years | 5 years |
| Annualized volatility | 75.12% | 65.89% | 74.89% |
| Dividend rate | 0% | 0% | 0% |
| Grant date share price | $0.670 | $0.365 | $0.580 |
| Share option fair value | $.496 | $0.198 | $0.354 |

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

iv. Weighted average common shares outstanding

| | 2015 | | 2014 | |
|---|---|---|---|---|
| | **Weighted average common shares- basic and diluted** | **Number of Common Shares** | **Weighted average common shares- basic and diluted** | **Number of Common Shares** |
| **Balance, January 1** | 179,737,241 | 179,737,241 | 134,462,561 | 134,462,561 |
| Shares repurchased under NCIB | (20,111) | (90,000) | - | - |
| Share options exercised | 33,117 | 108,500 | - | - |
| Warrants exercised | - | - | 19 | 46 |
| **Balance, March 31** | **179,750,247** | **179,755,741** | **134,462,580** | **134,462,607** |

## 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:

| | **2015 $** | **2014 $** |
|---|---|---|
| Program management | 823 | 896 |
| Program oversight | 25 | 58 |
| Clinical site costs | 624 | 932 |
| Diagnostic supply and training | 51 | 30 |
| Employee benefits | 114 | 108 |
| Consultants | 13 | 54 |
| **Total EUPHRATES** | **1,650** | **2,078** |

The trial costs have been included within operating loss in the statement of loss and comprehensive loss as required. Total trial costs since inception in 2010 are $27,540.

(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:

| | March 31 2015 $ | | March 31 2014 $ | |
|---|---|---|---|---|
| | All employees | Key management | All employees | Key management |
| Salaries | 603 | 324 | 578 | 316 |
| Bonuses | 90 | 90 | 90 | 90 |
| Short term employee benefits | 80 | 32 | 88 | 28 |
| Directors fees | 63 | 63 | 70 | 70 |
| Share- based compensation | 105 | 116 | 205 | 191 |
| Other | 6 | 1 | 3 | - |
| | **947** | **626** | **1,034** | **695** |

## 11. Private placements

i. On June 10, 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 was comprised of 45,051,186 common shares ("Shares") of the Company at a subscription price of $0.293 per Share, for aggregate gross proceeds of $13,200, of which (a) 17,064,846 Shares, for aggregate proceeds of $5,000, were sold to Toray; (b) 15,358,360 Shares, for aggregate gross proceeds of $4,500 were sold to Birch Hill Equity Partners Management Inc.; (c) 9,726,958 Shares for aggregate proceeds of $2,850, were sold to other investors; (d) 2,901,022 Shares, for aggregate proceeds of $850 were sold to other related parties at the date of the transaction.

ii. The Tranche "B" component of the Offering was 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 Company provided written notice to Toray to exercise the Call Right granted by Toray to the Company on March 14, 2015.On April 1, 2015,Toray purchased 9,041,592 common shares ("Shares") at a subscription price of $0.553 per Share (representing the 20 day volume weighted average trading price of the Shares on the TSX for the 20 day period ended March 13, 2015) for aggregate gross proceeds of $5,000.

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

iii. . On April 1, 2015, pursuant to their anti-dilution rights, Birch Hill acquired 2,007,872 Shares at a subscription price of $0.553 per Share, for aggregate gross proceeds of $1,110

## 12. Related party transactions

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

Toray holds 42,773,105 Shares, subsequent to the completion of Tranche "B' component of the financing as described in Note 11, representing approximately 22.4% (2014 – 12.4%) 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.

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

| | March 31 2015 $ | March 31 2014 $ |
|---|---|---|
| **Revenue** | | |
| Toray Medical Co., Ltd. | 62 | 54 |
| Toray International Italy S.r.l. | 64 | - |
| **Purchases** | | |
| Toray International America Inc. | 56 | - |
| **Reimbursement of trial related expenses** | | |
| Toray Industries, Inc. | 96 | - |
| **Due from (to)** | | |
| Toray Industries, Inc. | 101 | - |
| Toray International America Inc. | (58) | - |

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

Birch Hill, through a number of its funds and an investee company, holds 32,984,718 common shares of the Company representing approximately a 17.3% ownership interest, calculated on a non-diluted basis. Birch Hill was not a related party in 2014 since it held less than 10% of the issued and outstanding common shares.

Birch Hill is entitled to nominate one director to the Company's Board of Directors 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.

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

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

There are no other related party transactions.