

Spectral Medical Inc.

Condensed Interim Consolidated Financial Statements

March 31, 2017

(Unaudited)

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

Spectral Medical Inc.

Condensed Interim Consolidated Financial Statements

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Spectral Medical Inc.

Condensed Interim Consolidated Statements of Financial Position
(Unaudited)

(in thousands of Canadian dollars)

	Notes	March 31 2017 \$	December 31 2016 \$
Assets			
Current assets			
Cash		3,714	5,080
Trade and other receivables		792	642
Inventories		259	244
Prepayments and other assets		299	166
		5,064	6,132
Non-current assets			
Property and equipment		667	634
Intangible asset		328	334
		995	968
Total assets		6,059	7,100
Liabilities			
Current liabilities			
Trade and other payables		758	1,112
Deferred revenue		131	166
Total liabilities		889	1,278
Equity			
Share capital	9	63,084	63,084
Contributed surplus		7,849	7,849
Share-based compensation		4,413	4,103
Warrants		132	132
Deficit		(70,308)	(69,346)
Total equity		5,170	5,822
Total liabilities and equity		6,059	7,100

Contingencies and commitments (Note 8)

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

Spectral Medical Inc.

Condensed Interim Consolidated Statements of Loss and Comprehensive Loss
For the three months ended March 31, 2017 and 2016
(Unaudited)

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

	Notes	2017 \$	2016 \$
Revenue		941	1,062
Expenses			
Changes in inventories of finished goods and work-in-process		15	25
Raw materials and consumables used		52	203
Employee benefits	9,12	1,080	1,153
Consulting and professional fees		320	2,071
Product development		50	-
Regulatory and investor relations		96	207
Travel and entertainment		86	209
Depreciation and amortization		54	42
Foreign exchange loss		3	15
Other expenses		147	144
		1,903	4,069
Operating loss		(962)	(3,007)
Finance income		-	13
Loss and comprehensive loss for the period		(962)	(2,994)
Basic and diluted loss per common share	10	(0.005)	(0.02)
Weighted average number of common shares outstanding	10	207,165,587	198,015,803

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

Spectral Medical Inc.

Condensed Interim Consolidated Statements of Changes in Equity
For the three months ended March 31, 2017 and 2016
(Unaudited)

(in thousands of Canadian dollars)

	Notes	Issued capital Number	\$	Contributed surplus \$	Share-based compensation \$	Warrants \$	Deficit \$	Total equity \$
Balance, January 1, 2016		190,771,405	53,058	7,849	3,723	-	(59,197)	5,433
Bought deal prospectus offering	9	15,106,804	9,402	-	-	-	-	9,402
Share options exercised	9	855,000	458	-	(192)	-	-	266
Loss and comprehensive loss for the period		-	-	-	-	-	(2,994)	(2,994)
Share-based compensation	9	-	-	-	359	-	-	359
Balance, March 31, 2016		206,733,209	62,918	7,849	3,890	-	(62,191)	12,466
Balance, January 1, 2017		207,165,587	63,084	7,849	4,103	132	(69,346)	5,822
Loss and comprehensive loss for the period		-	-	-	-	-	(962)	(962)
Share-based compensation	9	-	-	-	310	-	-	310
Balance, March 31, 2017		207,165,587	63,084	7,849	4,413	132	(70,308)	5,170

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Spectral Medical Inc.

Condensed Interim Consolidated Statements of Cash Flows
For the three months ended March 31, 2017 and 2016
(Unaudited)

(in thousands of Canadian dollars)

	Notes	2017 \$	2016 \$
Cash flow provided by (used in)			
Operating activities			
Loss and comprehensive loss for the period		(962)	(2,994)
Adjustments for:			
Depreciation on property and equipment		48	35
Amortization of intangible asset		6	6
Share-based compensation	9	310	359
Changes in items of working capital :			
Trade and other receivables		(150)	(256)
Inventories		(15)	(82)
Prepayments and other assets		(133)	(160)
Trade and other payables		(354)	(22)
Deferred revenue		(35)	(9)
Net cash used in operating activities		(1,285)	(3,123)
Investing activities			
Property and equipment expenditures		(81)	(53)
Net cash used in investing activities		(81)	(53)
Financing activities			
Bought deal prospectus offering	13	-	9,402
Share options exercised	9	-	266
Net cash provided by financing activities		-	9,668
(Decrease)increase in cash		(1,366)	6,492
Cash, beginning of period		5,080	6,369
Cash, end of period		3,714	12,861

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Spectral Medical Inc.

Notes to the Condensed Interim Consolidated Financial Statements
For the three months ended March 31, 2017 and 2016
(Unaudited)

(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. 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 septic shock 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 consolidated financial statements of Spectral for the three months ended March 31, 2017, have been prepared in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board (IFRS) as set out in the CPA Canada Handbook, applicable to the preparation of condensed interim consolidated financial statements, including IAS 34, "Interim Financial Reporting". The condensed interim consolidated financial statements should be read in conjunction with the annual consolidated financial statements for the year ended December 31, 2016, which have been prepared in accordance with IFRS. These condensed interim consolidated financial statements were approved by the Board of Directors for issue on May 11, 2017.

3. Significant accounting policies

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

4. Critical accounting estimates and judgments

The preparation of condensed interim consolidated 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, 2016.

5. Accounting standards adopted in the current period

There are no new IFRSs or IFRCs that were adopted for the first time for this interim period.

6. Accounting standards issued but not yet applied

There are no new IFRSs or IFRCs that are effective for the first time for this interim period that would be expected to materially affect the Company.

Spectral Medical Inc.

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

7. 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 consolidated 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 statements as at December 31, 2016. 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 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. Trade and other payables were \$758 as at March 31, 2017 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.

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8. Contingencies and commitments

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

	2017
	\$
Program management	643
Program oversight	105
Clinical site costs	-
Diagnostic supply and training	56
Employee benefits	312
	1,116

Future commitments for the trial are related primarily to the final PMA submission to the FDA and clinical site close outs.

- 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 as purchase and sale agreements, confidentiality agreements, engagement letters with advisors and consultants, leasing contracts and license agreements. These indemnification arrangements may sometimes require such third parties to compensate counterparties 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. No accruals have been required to be made as at March 31, 2017 with respect to these agreements.

9. Share capital and other equity reserves

- i. The Company is authorized to issue an unlimited number of common shares ("Shares").
- ii. On July 4, 2016, 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 Shares. Pursuant to the notice, the Company is able to purchase up to 4,134,664 of its Shares, representing approximately 2% of its issued and outstanding Shares, during the twelve month period commencing July 6, 2016 and ending July 5, 2017.

The Company did not repurchase any Shares under this NCIB as of March 31, 2017.

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ii. Details of share options are as follows:

Under the Company's 2008 Amended Stock Option Plan, the total number of Shares that may be optioned to any director, officer, employee or consultant shall not exceed 5% of the total issued and outstanding shares at the date of the grant of the option. The aggregate number of shares issuable under the Plan shall not exceed 10% of the total number of Shares issued and outstanding.

During the three month period ended March 31, the Company granted the following share options to directors, officers, employees and consultants at the discretion of the Board of Directors.

2017			2016		
Date	Number of share options	Exercise price	Date	Number of share options	Exercise price
February 28, 2017	1,637,505	\$0.30	February 1, 2016	1,420,000	\$0.73
			March 29, 2016	180,000	\$0.76

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 consultants, 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 February 1, 2016 will be fully vested by February 1, 2019. The share options issued March 29, 2016 were fully vested on the grant date. The contractual life of each share option is five years, except for the share options granted on March 29, 2016, which is two 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 and two years respectively.

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

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						2016	
Grant date	Risk-free interest rate	Expected life	Annualized volatility	Dividend rate	Grant date share price	Share option fair value	
February 1, 2016	0.67%	5 years	74.04%	0%	\$0.72	\$0.429	
March 29, 2016	0.51%	2 years	64.39%	0%	\$0.76	\$0.269	

						2017	
Grant date	Risk-free interest rate	Expected life	Annualized volatility	Dividend rate	Grant date share price	Share option fair value	
February 28, 2017	1.09%	5 years	123.09%	0%	\$0.29	\$0.242	

				2017				2016
	Weighted average exercise price per share \$	Share options		Weighted average exercise price per share \$	Share options			
		All optionees	Key management		All optionees	Key management		
January 1	0.48	5,591,872	4,163,500	0.37	5,086,500	4,143,500		
Granted	0.30	1,637,505	1,637,505	0.73	1,600,000	950,000		
Forfeited/cancelled	-	-	-	-	-	-		
Exercised	0.31	-	-	0.31	(855,000)	(730,000)		
Expired	0.29	(585,000)	(585,000)	0.32	(200,000)	(200,000)		
Balance, March 31	0.45	6,644,377	5,216,005	0.48	5,631,500	4,163,500		

Of the 6,644,377 outstanding share options (2016: 5,631,500), 5,273,405 share options (2016: 3,986,173) were exercisable.

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10. Loss per common share

The following table sets forth the computing of basic and diluted loss per share:

	2017 \$	2016 \$
Numerator for basic and diluted loss per common share available to common shareholders	(955)	(2,994)
Denominator for basic and diluted loss per common share	207,165,587	198,015,803
Basic and diluted loss per common share	(0.005)	(0.02)

For the periods noted above, the computation of diluted loss per common share is equal to the basic loss per common share due to the anti-dilutive effect of the outstanding share options and warrants.

Weighted average common shares outstanding

	2017		2016	
	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	207,165,587	207,165,587	190,771,405	190,771,405
Bought deal prospectus offering	-	-	6,919,175	15,106,804
Share options exercised	-	-	325,223	855,000
Balance, March 31	207,165,587	207,165,587	198,015,803	206,733,209

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11. 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 septic shock that removes endotoxin from the bloodstream.

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

	2017	2016
	\$	\$
Program management	164	1,017
Program oversight	46	48
Clinical site costs	13	916
Diagnostic supply and training	16	174
Employee benefits	101	111
Consultants	-	29
Total EUPHRATES	340	2,295

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 \$40,063.

12. Employee benefits

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

		2017		2016
		\$		\$
	All	Key	All	Key
	employees	management	employees	management
Salaries	633	334	632	315
Bonuses	5	-	90	90
Short term employee benefits	95	39	76	31
Directors' fees	62	62	79	79
Share-based compensation	283	274	271	223
Other	2	-	5	-
	1,080	709	1,153	738

Executive employment agreements allow for additional payments of approximately \$1,832 if the individuals are terminated without cause and approximately \$2,373 in the event of a change in control.

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13. Bought deal prospectus offering

On February 18, 2016, the Company closed a bought deal prospectus offering ("the Offering") resulting in the issuance of 14,300,000 Shares for gross proceeds of \$10,010.

On February 24, 2016, an additional 806,804 Shares were issued by the Company resulting in gross proceeds of \$565 in connection with the underwriters' exercise of their over-allotment option.

In total, the Company issued 15,106,804 Shares for aggregate gross proceeds of \$10,575. The Company received net proceeds of \$9,399 which will be used to fund its EUPHRATES trial and for working capital and general corporate purposes.

The Company also issued 906,408 broker warrants to the underwriters representing 6% of the total number of shares sold pursuant to the bought deal financing. Each broker warrant entitles the holder thereof to acquire one Share at a price of \$0.70 per Share for a period of 24 months from the closing date.

14. Related party transactions

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

Toray holds 45,630,105 Shares of the Company as at March 31, 2017, representing approximately 22.0% (2016 – 22.1%) 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 Shares issued and outstanding calculated on a non-diluted basis.

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

	2017	2016
	\$	\$
Revenue		
Toray Medical Co., Ltd.	83	18
Toray International Italy S.r.l.	-	-
Purchases		
Toray Industries, Inc.	-	101
Toray International America Inc.	-	-
Due from (to)		
Toray Medical Co., Ltd.	83	18
Toray Industries, Inc.	-	(95)
Toray International America Inc.	-	-

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

Birch Hill, through a number of its funds and an investee company, holds 33,517,718 Shares of the Company as at March 31, 2017 representing approximately a 16.2% (2016 – 16.2%) ownership interest, calculated on a non-diluted basis.

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 Shares of the Company calculated on a non-diluted basis.

iii. Key management consists of the Company's four executive officers and its' Board of Directors. Compensation of key management is disclosed in Note 12.

There are no other related party transactions.