

EBR SYSTEMS, INC.
CONSOLIDATED FINANCIAL REPORT
DECEMBER 31, 2019

EBR SYSTEMS, INC.
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INDEPENDENT AUDITOR'S REPORT

To the Board of Directors
EBR Systems, Inc.
480 Oakmead Parkway
Sunnyvale, California 94085

Report on Consolidated Financial Statements

We have audited the accompanying consolidated financial statements of EBR Systems, Inc. and Subsidiary (collectively, the "Company"), which comprise the consolidated balance sheet as of December 31, 2019, and the related consolidated statements of operations, stockholders' deficit and cash flows for the year then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence obtained is sufficient and appropriate to provide a basis for our audit opinion.

To the Board of Directors
EBR Systems, Inc

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of EBR Systems, Inc. and Subsidiary as of December 31, 2019, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter Regarding Going Concern

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 2 to the consolidated financial statements, the Company has suffered recurring losses and cash flow deficits from operations, which raise substantial doubt on its ability to continue as a going concern. Management's evaluation of the events and conditions and management's plans regarding these matters are also described in Note 2 to the consolidated financial statements. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty. Our opinion is not modified with respect to this matter.

A handwritten signature in cursive script that reads "SingerLewak LLP".

SingerLewak LLP

October 2, 2020

EBR SYSTEMS, INC.
BALANCE SHEET
DECEMBER 31, 2019

ASSETS

Current assets

Cash and cash equivalents	\$ 7,285,499
Accounts receivable	172,191
Inventories	2,840,193
Prepaid expenses	231,198
Other current assets	<u>837,598</u>

Total current assets 11,366,679

Property and equipment, net

869,829

Other assets

150,860

Total assets

\$ 12,387,368

LIABILITIES AND SHAREHOLDERS' DEFICIT

Current liabilities

Current portion of debt	\$ 1,000,000
Accounts payable and accrued expenses	<u>4,615,980</u>

Total current liabilities 5,615,980

Derivative liability

3,128,365

Non-current portion of debt

17,468,749

Total liabilities

26,213,094

Commitments and Contingencies (Note 9)

Shareholders' deficit

New Series B Convertible preferred stock, \$0.0001 par value, authorized, 195,000,000 shares, issued and outstanding 81,368,446 shares	8,137
New Series A convertible preferred stock, \$0.0001 par value, authorized 3,523,428 shares, issued and outstanding 3,488,010 shares	349
Common stock, authorized, 140,000,000 shares, issued and outstanding 13,120,274 shares	1,312
Additional paid-in capital	164,297,587
Accumulated deficit	<u>(178,133,111)</u>

Total shareholders' deficit

(13,825,726)

Total liabilities and shareholders' deficit

\$ 12,387,368

See notes to financial statements

EBR SYSTEMS, INC.
STATEMENT OF OPERATIONS
FOR THE YEAR ENDED DECEMBER 31, 2019

Revenues

Sales	\$ 1,293,935
	<u>1,293,935</u>

Costs and operating expenses

Cost of goods sold (including write down of inventory to net realizable value of \$2,100,102)	7,073,901
General and administrative	2,259,949
Research and development	11,053,085
Selling and marketing	<u>6,295,367</u>
	<u>26,682,302</u>

Loss from operations	<u>(25,388,367)</u>
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Interest and other income (expense), net

Interest income	122,890
Gain on extinguishment of debt	1,553,837
Interest and other expenses	<u>(1,101,122)</u>
	<u>575,605</u>

Loss before provision for income tax	(24,812,762)
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Provision for income tax	<u>-</u>
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Net loss	<u>\$ (24,812,762)</u>
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See notes to financial statements

EBR SYSTEMS, INC.
STATEMENT OF SHAREHOLDERS' EQUITY (DEFICIT)
FOR THE YEAR ENDED DECEMBER 31, 2019

	New Series B		Convertible Preferred Stock		New Series A		Common Stock		Additional Paid In Capital	Accumulated Deficit	Total Shareholders' Equity (Deficit)
	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount			
Balance at January 1, 2019	75,000,951	\$ 7,500	3,488,010	\$ 349	12,957,996	\$ 1,296	157,462,394	\$ (153,320,349)	\$ 4,151,190		
Issuance of Series B Convertible Preferred Stock, net issuance costs of \$151,519	6,367,495	637	-	-	-	-	5,097,844	-	5,098,481		
Warrants issued in connection with convertible notes	-	-	-	-	-	-	1,329,621	-	1,329,621		
Exercise of stock options	-	-	-	-	168,378	17	26,925	-	26,942		
Cancelled unvested shares	-	-	-	-	(6,100)	-	-	-	-		
Stock compensation expense	-	-	-	-	-	-	380,802	-	380,802		
Net loss	-	-	-	-	-	-	-	(24,812,762)	(24,812,762)		
Balance at December 31, 2019	81,368,446	8,137	3,488,010	349	13,120,274	1,313	164,297,586	(178,133,111)	\$ (13,825,726)		

See notes to financial statements

EBR SYSTEMS, INC.
STATEMENTS OF CASH FLOWS
FOR THE YEAR ENDED DECEMBER 31, 2019

Cash flows from operating activities

Net loss	\$ (24,812,762)
Adjustments to reconcile net loss to net cash used in operating activities:	
Stock-based compensation	380,802
Depreciation and amortization	210,954
Change in fair value of derivative liability	100,906
Non-cash interest expense	886,146
Gain from the extinguishment of debt	(1,553,837)
Changes in operating assets and liabilities:	
Accounts receivable	507,337
Inventories	1,461,032
Prepaid expenses	409,461
Other current assets	(151,400)
Accounts payable and accrued expenses	<u>1,503,873</u>

Net cash used in operating activities (21,057,488)

Cash flows from investing activities

Purchase of property and equipment	<u>(242,129)</u>
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Net cash used in investing activities (242,129)

Cash flows from financing activities

Payments of long term debt	(1,000,000)
Issuance costs related to preferred stock	(151,519)
Proceeds from exercise of stock options	26,942
Proceeds from issuance of convertible notes	<u>12,401,639</u>

Net cash provided by financing activities 11,277,062

Net decrease in cash and cash equivalents (10,022,555)

Cash and cash equivalents at beginning of year 17,308,054

Cash and cash equivalents at end of year **\$ 7,285,499**

Supplemental disclosure of cash flows information

Cash paid for interest	<u>\$ 105,692</u>
Cash paid for taxes	<u>\$ 31,282</u>

Noncash financing transaction:

Conversion of debt and accrued interest into Series B preferred stock	<u>\$ 5,250,000</u>
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See notes to financial statements

EBR SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – ORGANIZATION AND NATURE OF OPERATIONS

Nature of Business

EBR Systems, Inc. (“EBR” or the “Company”) is a research and development venture pursuing novel approaches in cardiac rhythm management. In 2015, the Company received European CE Mark approval for the world’s first wireless cardiac pacing system for heart failure. In 2016, EBR announced its first commercial implants of its wireless cardiac pacing system.

The Company operates a wholly owned subsidiary entity in Australia which establishes clinical trial sites in Australia and works on intellectual property development and on FDA approval. The subsidiary was incorporated on February 23, 2017 and is currently in clinical trials.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Liquidity and Management’s Plans

The Company’s operations have historically been financed through the issuance of common and preferred stock and debt. Since inception, the Company has incurred significant losses and negative cash flows from operations as it is expending considerable resources in developing its products and other activities. These activities have resulted in losses from operations, which are expected to continue into future years. During the year ended December 31, 2019, the Company incurred a net loss of \$24.8 million and had negative cash flows from operating activities of \$21.1 million. As of December 31, 2019, the Company had an accumulated deficit of \$178.1 million and cash and cash equivalents of \$7.3 million.

The Company will require additional financing to continue its research and development activities, conduct clinical studies, obtain regulatory approvals and fund operations. Failure to complete an additional financing or manage discretionary spending may adversely impact the Company’s ability to achieve its intended business objectives.

Accounting standards require that management evaluate whether the Company has adequate financial resources to continue as a going concern for one year after the date that these consolidated financial statements are available to be issued. Management has determined that additional funds will be needed to continue as a going concern for the period defined in the accounting standards. Because obtaining future funding is not assured, there is substantial doubt about the Company’s ability to continue as a going concern for one year after the date that these consolidated financial statements are available to be issued.

Basis of Presentation

The accompanying consolidated financial statements are prepared on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America (“GAAP”).

EBR SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Principles of Consolidation

The financial statements include the accounts of the Company and its wholly owned foreign subsidiary, EBR Systems (AUST) Pty Ltd. All significant intercompany transactions and balances have been eliminated in consolidation.

Foreign Currency Translation

The Company has determined that the functional currency of its foreign subsidiary is the U.S. dollar. The monetary assets and liabilities of the Company's foreign subsidiary have been re-measured into U.S. dollars using the exchange rates in effect at year end, the non-monetary assets and liabilities have been re-measured into U.S. dollars using historical exchange rates, and the revenues and expenses transactions have been re-measured into U.S. dollars using the average exchange rates in effect during the year ended December 31, 2019. Adjustments resulting from re-measurement into U.S. dollars are reported as part of other income or expense in the statement of operations.

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 disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenditures/expenses during the reporting periods. Significant estimates include the valuation of the derivative liability and valuation of inventories at net realizable value.

Cash and Cash Equivalents

EBR considers all highly liquid instruments with an initial maturity date of 90 days or less when purchased to be cash equivalents. All investments are considered as cash equivalents.

Accounts Receivable

Accounts receivable are recorded at the invoiced amount and are not interest bearing. EBR maintains an allowance for doubtful accounts to reserve for potentially uncollectible trade receivables. EBR reviews its trade receivables by aging category to identify specific customers with known disputes or collection issues. EBR exercises judgment when determining the adequacy of these reserves as it evaluates historical bad debt trends, general economic conditions in the United States and internationally, and changes in customers' financial condition. EBR considers amounts to be past due and delinquent once the payment terms have elapsed. Uncollectible receivables are written off when all efforts to collect have been exhausted and recoveries are recognized when they are received. Management evaluated the accounts and determined that no allowance is needed as of December 31, 2019.

EBR SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Concentration of Credit Risk

Financial instruments that potentially subject the Company to credit risk consist primarily of cash and cash equivalents and accounts receivable. Cash and cash equivalents are deposited with federally insured commercial banks in the United States and cash balances may, at times, be in excess of the Federal Deposit Insurance Corporation (“FDIC”) limits. Management believes that the financial risks associated with its cash and cash equivalents are minimal as the Company’s cash deposits are held at creditworthy commercial banks.

Accounts receivable are considered past due based on payment terms with customers. Management performs ongoing credit evaluations of its customers and monitors the accounts receivable balances on a regular basis. Accounts receivable are written off when all methods of collection have been exhausted. Such write-offs have been within the range of management’s expectations.

Management believes its credit acceptance, billing and collection policies are adequate to minimize potential credit risk.

The Company has a concentration of credit risk with respect to the volume of business transacted with certain customers. Two customers accounted for approximately 23% (12% and 11%) of the sales for the year ended December 31, 2019. Four customers represented approximately 84% (44%, 15%, 13%, 12%) of the Company’s accounts receivable as of December 31, 2019.

Fair Value of Financial Instruments

GAAP defines fair value, establishes a consistent framework for measuring fair value and expands disclosure requirements about fair value measurements. The statement, among other things, requires the Company to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

This includes applying the fair value concept to (i) nonfinancial assets and liabilities initially measured at fair value in business combinations, (ii) reporting units or nonfinancial assets and liabilities measured at fair value in conjunction with goodwill impairment testing, (iii) other nonfinancial assets and liabilities measured at fair value in conjunction with impairment assessments, and (iv) asset retirement obligations initially measured at fair value. The statement established a hierarchal disclosure framework associated with the level of pricing observability utilized in measuring fair value. This framework defined three levels of inputs to the fair value measurement process and requires that each fair value measurement be assigned to a level corresponding to the lowest level input that is significant to the fair value measurement in its entirety. The three broad levels of inputs defined by the hierarchy are as follows:

- Level 1 Inputs – quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date,

EBR SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Fair Value of Financial Instruments (Continued)

- Level 2 Inputs – inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full-term of the asset or liability, and
- Level 3 Inputs – unobservable inputs for the asset or liability. These unobservable inputs reflect the entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability and are developed based on the best information available in the circumstances (which might include the reporting entity's own data).

As of December 31, 2019, the Company had \$3,055,831 invested in a U.S. federal treasury obligation fund, which is measured as Level 1, and is considered to be a cash equivalent.

In 2019, the Company made Level 3 fair value measurements in connection with the embedded derivative in its issuance of convertible notes (see Note 5).

Derivative Liability

For the conversion features in certain of the Company's convertible notes, the Company assesses whether the economic characteristics of the embedded derivative (recorded as derivative liability) are clearly and closely related to the economic characteristics of the remaining component of these convertible notes (i.e., the host contract) and whether a separate instrument with the same terms as the embedded instrument would meet the definition of a derivative instrument. When it is determined that (a) the embedded derivative possesses economic characteristics that are not clearly and closely related to the economic characteristics of the host contract, and (b) a separate instrument with the same terms would qualify as a derivative instrument, the embedded derivative is separated from the host contract and carried at fair value through net income.

Inventory

Inventory is stated at the lower of standard cost (which approximates actual cost on a first-in, first-out basis) or net realizable value. Cost is determined on a weighted-average basis, which approximates actual cost on a first-in, first-out (FIFO) basis.

EBR SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Revenue Recognition

EBR recognizes revenue when the earnings process is complete, and revenue is measurable. Gross sales consist primarily of revenue from clinical trial reimbursements. Net revenues represent gross sales, less provision for returns estimated based on historical returns experience. Revenue is recognized when all the following criteria are met:

- There is persuasive evidence of an arrangement;
- The service has been provided to the customer;
- The collection of the fees is reasonably assured and
- The amount of fees to be paid by the customer is fixed or determinable.

Revenue recognition generally occurs upon use by its customers (i.e. upon implantation of the device) and acknowledgement of reimbursement or payment.

Cost of Goods Sold

Cost of goods sold consists of the costs to manufacture the product including any third-party conversion costs and shipping and handling charges.

Research and Development Costs

All research and development costs are expensed as incurred.

Property and Equipment

Property and equipment is recorded at cost and includes improvements that significantly add to productive capacity or extend the useful life. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, which is three to eight years. Repair and maintenance costs that do not increase the useful lives and/or enhance the value of the assets are charged to operations as incurred. Leasehold improvements are stated at cost and amortized over the lesser of the term of the respective leases or the assets' useful lives.

The Company evaluates its long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Long-lived assets consist primarily of property and equipment.

Recoverability of assets is measured by a comparison of the carrying amount of an asset group to future net cash flows expected to be generated by the asset group. If such assets are considered to be impaired, the impairment charge is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value, less cost to sell. The Company did not recognize any impairment charges associated with long-lived assets during the year ended December 31, 2019.

EBR SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases as well as net operating loss and tax credit carryovers. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled.

The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is established when necessary to reduce deferred tax assets to the amounts expected to be realized.

Significant judgment is required in determining any valuation allowance recorded against deferred tax assets. In assessing the need for a valuation allowance, the Company considers all available evidence, including past operating results, estimates of future taxable income, and the feasibility of tax planning strategies.

In the event that the Company changes its determination as to the amount of deferred tax assets that is more likely than not to be realized, the Company will adjust its valuation allowance with a corresponding impact to the provision for income taxes in the period in which such determination is made.

The Company follows the authoritative guidance regarding uncertain tax positions. This guidance requires that realization of an uncertain income tax position must be more likely than not (i.e., greater than 50% likelihood of receiving a benefit) before it can be recognized in the financial statements. The guidance further prescribes the benefit to be realized assumes a review by tax authorities having all relevant information and applying current conventions. The Company recognizes potential accrued interest and penalties related to unrecognized tax benefits as income tax expense.

Recently Issued Accounting Pronouncements

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). The guidance in this ASU supersedes the leasing guidance in Topic 840, Leases. Under the new guidance, lessees are required to recognize lease assets and lease liabilities on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the statement of operations. The new standard is effective for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. Management is currently evaluating the new standard and its possible impacts on the Company's financial statements.

EBR SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Recently Issued Accounting Pronouncements (Continued)

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606) (“ASU 2014-09”), requiring an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The updated standard will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective and permits the use of either a full retrospective or modified retrospective with cumulative effect transition method. The FASB has also issued several updates and deferrals to ASU 2014-09 making it effective for annual reporting periods beginning after December 15, 2019. The Company is currently evaluating the impact of the adoption of this guidance on its consolidated financial statements.

In June 2018, the FASB issued ASU No. 2018-07, Compensation—Stock Compensation (Topic 718): Improvements to Nonemployee Share-based Payment Accounting. The amendments in this ASU expand the scope of Topic 718 to include share-based payment transactions for acquiring goods and services from nonemployees. An entity should apply the requirements of Topic 718 to nonemployee awards except for specific guidance on inputs to an option pricing model and the attribution of cost (that is, the period of time over which share-based payment awards vest and the pattern of cost recognition over that period). The amendments specify that Topic 718 applies to all share-based payment transactions in which a grantor acquires goods or services to be used or consumed in a grantor’s own operations by issuing share-based payment awards. The amendments also clarify that Topic 718 does not apply to share-based payments used to effectively provide (1) financing to the issuer or (2) awards granted in conjunction with selling goods or services to customers as part of a contract accounted for under Topic 606, Revenue from Contracts with Customers. The amendments in the ASU are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted, but no earlier than an entity’s adoption date of Topic 606. The Company is currently evaluating the impact of the adoption of this guidance on its consolidated financial statements.

NOTE 3 – INVENTORY

Inventory consists of the following as of December 31, 2019:

Raw materials	\$ 400,785
Work in progress	192,965
Finished goods	<u>2,264,443</u>
Total	<u>\$ 2,840,193</u>

During 2019, the Company had written down its inventory to its net realizable and recorded a \$2,100,102 write down which is included in cost of goods sold in the statement of operations.

EBR SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 – PROPERTY AND EQUIPMENT

Property and equipment consist of the following as of December 31,:

Computer and software	\$ 301,183
Furniture	45,976
Office equipment	35,630
Lab equipment	275,215
Leasehold improvements	298,667
Production fixtures	242,957
Tooling	242,801
Clinical equipment	92,612
Production equipment and machinery	<u>454,005</u>
	1,989,046
Less accumulated depreciation and amortization	<u>(1,119,217)</u>
Total	<u>\$ 869,829</u>

NOTE 5 – DEBT

Silicon Valley Bank Term Loan

The Company has a loan and security agreement with Silicon Valley Bank with an outstanding balance of \$2,000,000 at December 31, 2019. Borrowings under the new loan bear interest at 3.75%. In 2019, the Company repaid \$1,000,000.

The agreement provides for the compliance with certain covenants of which the Company was in compliance at December 31, 2019. The agreement provides for delivery of audited financial statements within 210 days after December 31, 2019. The Company is in process of obtaining a formal extension of the delivery date of the audited financial statements to the issuance date.

This loan is secured by all of the Company's assets, except for its intellectual property but includes all proceeds from the sale of intellectual property.

Minimum annual payments are as follows:

2020	\$ 1,000,000
2021	<u>1,000,000</u>
Total	<u>\$ 2,000,000</u>

EBR SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 5 – DEBT (Continued)

Medtronic Term Loan

In March 2015, the Company entered into a loan agreement with a strategic partner (lender) of \$5,000,000 with an interest rate of eight percent. The principal and interest are due on February 1, 2020. The loan is not collateralized by any of the Company's assets and is not convertible.

The Company entered into a stock purchase agreement with an investor to issue 6,367,495 shares of New Series B preferred stock valued at \$5.25 million in exchange for the cancellation of all outstanding balances related to this loan effective September 12, 2019. In a separate agreement, the lender assigned the loan, including related interest, to the investor effective September 12, 2019. Prior to the conversion of the loan to equity on September 12, 2019, the total loan and related accrued interest totaled \$6.8 million. On September 12, 2019, the loan and related accrued interest was converted into shares of New Series B preferred stock. Accordingly, the Company recognized a gain from the extinguishment of the loan of \$1.6 million.

Convertible Notes

The Company has one prior year outstanding convertible note totaling \$9,020,589 which has a stated interest rate of 8% per annum and is convertible into ordinary shares of the Company's Australia subsidiary at \$0.725 per share. Interest is only due and payable in the event the Company declares a dividend on the New Series B Preferred Stock. As no such dividends have been declared to date there is no accrued interest recorded for this convertible note.

As of December 31, 2019, outstanding principal balance of these notes amounted to \$9,020,589. As of December 31, 2019, there was an associated unamortized beneficial-conversion feature of \$983,589, which was accounted for as a discount on the debt which is included in long-term liabilities. These notes mature in 2028.

On August 26, 2019, the Company issued convertible notes payable in the amount of \$12,401,639. As part of the agreement, the Company issued warrants to the notes payable holders to purchase 4,438,347 of New Series B shares of preferred stock at \$0.8245 per share and a term of 10 years. The Company classified these warrants as equity. Accordingly, the Company bifurcated the allocated fair value of these warrants, which resulted in the recording of additional paid in capital and debt discount of \$1,329,621. As of December 31, 2019, the related unamortized debt discount was \$1,139,675.

EBR SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 5 – DEBT (Continued)

Convertible Notes (Continued)

The assumptions used for determining the fair value of the warrants granted during the year ended December 31, 2019 are as follows:

Expected dividend yield (1)	0%
Risk-free interest rate (2)	1.49%
Expected volatility (3)	36.82%
Expected life (in years) (4)	10.00

- (1) The Company has no history or expectation of paying cash dividends on its preferred or common stock
- (2) The risk-free interest rate is based on the U.S. Treasury yield for a term consistent with the expected life of the awards in effect at the time of grant.
- (3) The Company estimates the volatility of its common stock at the date of grant based on the share price volatilities of comparable publicly traded companies.
- (4) The expected life of these warrants was based on the contractual life

These notes are convertible into the next qualified financing at 80% of the price per share in the qualified financing. For Australian purchasers, their warrants are for ordinary shares in the Company's Australian subsidiary. Upon exercise of the warrants, the ordinary shares are automatically exchangeable one-to-one into the US New Series B Preferred Stock. For the Australian purchasers of convertible notes, the notes are convertible into ordinary shares of the Company's Australian subsidiary. Upon conversion of the Australia convertible notes into ordinary shares, the ordinary shares become automatically exchangeable one-to-one into shares of the stock used to convert the US convertible notes. For financial statements purposes these warrants and convertible notes are accounted for in the same manner as the warrants and convertible notes issued to US purchasers. The Company accounted for the discounted conversion price mechanism features of these notes as an embedded derivative liability. At the time of issuance, the Company recorded a derivative liability and debt discount of \$3,027,459. As of December 31, 2019, the related unamortized debt discount was \$2,594,965.

The derivative liability is remeasured at its fair value at balance sheet date. As a result, the Company recorded a change in fair value of the derivative liability classified as part of interest and other expenses (increasing the derivative liability at end of the year) of \$100,906 in 2019.

The Company valued the derivative using a probability weighted expected return analysis and Black-Scholes model using level 3 assumptions. The most significant assumptions related to the probabilities assigned to different conversion settlement outcomes.

EBR SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 6 – STOCKHOLDERS’ EQUITY

In August 2019, the Company amended and restated its Articles of Incorporation to, among other items, (i) increase the number of authorized shares of common stock to 240,000,000 shares, (and ii) increase the number of authorized preferred stock to 198,523,428 (with 3,523,428 shares for New Series A preferred stock and 195,000,000 shares for New Series B preferred stock).

Common stock

The following table sets forth the shares of common stock reserved for future issuance as of December 31, 2019:

Convertible Preferred Stock	102,918,685
Options outstanding under the 2008 Stock Option Plan	29,958,361
Warrants outstanding	6,990,442
Additional equity awards that can be issued under the 2013 Stock Option Plan	<u>2,619,452</u>
Total	<u>142,486,940</u>

Preferred Stock

As discussed in Note 5, the Company issued 6,367,495 shares of New Series B preferred stock valued at \$5.25 million in exchange for the cancellation of all outstanding balance related to the Medtronic loan (see Note 5).

Voting

The holder of each share of series of preferred stock are entitled to the number of votes equal to the number of shares of common stock into which each share of the preferred stock could be converted immediately after the close of business on the record date. The holders of shares of preferred stock have voting rights and powers equal to the voting rights and powers of holders of common stock.

Dividends

The holder of shares of New Series B preferred stock shall first be entitled to receive dividends, out of any assets legally available, at the rate of \$0.06596 per share, noncumulative, payable quarterly when, as and if declared by the Board of Directors. The holder of shares of New Series A preferred stock shall be entitled to receive dividends, out of any assets legally available, in preference over common at the rate of \$0.06596, noncumulative, payable quarterly when, as and if declared by the Board of Directors. After payment of these dividends, additional dividend shall be distributed among all stockholders on a pro rata based on the number of shares of on “as if” converted to common stock.

EBR SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 6 – STOCKHOLDERS' EQUITY (Continued)

Preferred Stock (Continued)

Liquidation

In the event of any liquidation, dissolution or winding up of the Company, the holders of the New Series B preferred stock shall be entitled received to receive, prior and in preference to, any distribution of any assets of the Company to holders of shares of New Series A preferred stock and common stock and amount equal to an amount per share equal to \$0.8245 per share, plus all declared and unpaid dividends. If upon any such liquidation events, the assets of the Company shall be insufficient to make payment in full to all holders of New Series B, such assets shall be distributed among the holders of New Series B preferred stock ratably in proportion to the full amounts they would otherwise be entitled to.

In the event of any liquidation, dissolution or winding up of the Company, after the payment to the holders of New Series A preferred, the holders of the New Series A preferred stock shall be entitled received to receive, prior and in preference to, any distribution of any assets of the Company to holders of shares of common stock equal to an amount per share equal to \$0.8245 per share plus all declared and unpaid dividends. If upon any such liquidation events, the assets of the Company shall be insufficient to make payment in full to all holders of New Series A preferred stock, such assets shall be distributed among the holders of New Series A preferred stock ratably in proportion to the full amounts they would be entitled to.

Conversion

Each share of New Series A and New Series B preferred stock may, at the option of the holder, be converted at any time into shares of common stock at the conversion price, as defined, subject to adjustments as described in its articles of incorporation. The initial conversion price and current conversion price of New Series A and New Series B preferred stock is equal to the original issue prices of \$0.8245 per share.

The preferred stock shall automatically convert into common shares, subject to conversion price adjustments, as defined, upon the written consent of two-thirds of the holders of the preferred stock, or immediately prior to a qualified initial public offering. Holders of the Preferred stock are entitled to vote their number of shares in a manner equal to the number of shares of common stock then issuable upon conversion of the Preferred stock. The Preferred Shareholders are entitled to liquidation preferences of \$0.8245 per share, in the event of any liquidation, dissolution or winding up of the Company prior to any distribution to common shareholders of any remaining assets. The Preferred Shareholders have a non-cumulative dividend preference, when, and if, a dividend is declared by the Board of Directors. Should the Company issue additional shares at a purchase price below the original Preferred Share purchase price, then the conversion ratio of the Preferred stock to Common Shares shall be adjusted to a broad-based weighted average formula to provide anti-dilution protection. The Preferred Shareholders have first-offer-to purchase rights on future sales of securities.

EBR SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 6 – STOCKHOLDERS' EQUITY (Continued)

Preferred Stock (Continued)

Redemption

The preferred stock has no redemption provisions.

NOTE 7 – STOCK BASED COMPENSATION

In 2003, the Board of Directors adopted the EBR Systems, Inc. 2003 Stock Option Plan (the 2003 Plan). In the plan, the Board of Directors approved 706,155 shares for issuance to officers, directors, employees and consultants. On May 6, 2013, the 2003 Plan expired, and no new stock options may be granted under the 2003 Plan from and after such date.

In 2013, the Board of Directors adopted the EBR Systems, Inc. 2013 Equity Incentive Plan (the 2013 Plan). In the plan, the Board of Directors approved 3,466,499 shares for issuance under this plan.

Both 2003 Plan and 2013 Plan requires that the option price may not be less than the fair market value of the stock at the date the option is granted, and that the stock must be paid for in full at the time the option is exercised. All options expire on a date determined by the Board of Directors, but not later than ten years from the date of grant. The options vest ratably over a four-year period, beginning one year from the date of grant. In 2017, the Board of Directors amended the 2013 Plan to increase the reserved shares to 23,867,036 shares.

The fair value of the shares of common stock underlying stock options was determined by the Company's Board of Directors. Because there was no public market for the Company's common stock, the Board of Directors determined fair value of the common stock at the time of grant of the option by considering a number of objective and subjective factors including important developments in the Company's operations, valuations performed by an independent third-party, sales of preferred stock, actual operating results and financial performance, the conditions in the biotechnology industry and the economy in general, the stock price performance and volatility of comparable public companies, and the lack of liquidity of the Company's common stock, among other factors.

EBR SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 7 – STOCK BASED COMPENSATION (Continued)

Specifically, the fair value of each option award is estimated on the date of grant using the Black-Scholes option pricing model. The expected life of the options granted is derived from the award's vesting period and the award recipient's exercise history, if applicable, and represents the period of time that the options are expected to be outstanding. The risk-free rate for periods within the expected life of the option is based on the U.S. Treasury note rate at the time of the grant corresponding to the expected life. The assumptions used for determining the fair value of the options granted during the year ended December 31, 2019 are as follows:

Expected dividend yield (1)	0%
Risk-free interest rate (2)	1.79% - 2.63%
Expected volatility (3)	36.40% - 38.48%
Expected life (in years) (4)	7.00

- (1) The Company has no history or expectation of paying cash dividends on its common stock.
- (2) The risk-free interest rate is based on the U.S. Treasury yield for a term consistent with the expected life of the awards in effect at the time of grant.
- (3) The Company estimates the volatility of its common stock at the date of grant based on the share price volatilities of comparable publicly traded companies.
- (4) The expected life of stock options granted under the Plan was based on the simplified method.

Stock option balances as of December 31, 2019 are as follows:

	<u>Shares</u>	<u>Weighted Average Exercise Price Per Share</u>	<u>Weighted Average Remaining Contractual Life (in years)</u>
Outstanding at December 31, 2018	22,429,655	\$ 0.16	
Granted	13,521,683	\$ 0.15	
Exercised	(168,378)	\$ 0.16	
Cancelled	<u>(5,824,599)</u>	\$ 0.16	
Outstanding at December 31, 2019	<u>29,958,361</u>	\$ 0.15	8.99
Vested and expected to vest at December 31, 2019	<u>29,958,361</u>	\$ 0.15	8.99
Exercisable at December 31, 2019	<u>1,867,775</u>	\$ 0.16	8.46

EBR SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 7 – STOCK BASED COMPENSATION (Continued)

There was no intrinsic value for stock options exercised during the year ended December 31, 2019.

During 2019, in connection with the change in status of a key employee, the company cancelled this employee's unvested option on 3,084,784 common shares which had an exercise price of \$0.16 per share and reissued an option on 3,841,286 common shares (which included the replacement of the cancelled option on 3,084,784 shares) at an exercise price of \$0.14 per share. Incremental stock compensation expense associated with this option modification is approximately \$83,000, which is being recognized over the 24-month vesting period of the reissued option.

As of December 31, 2019, there was \$1,309,078 of unrecognized compensation cost related to stock options granted under the Plan. That cost is expected to be recognized over a weighted-average period of 2.87 years.

Total stock-based compensation costs recorded during the years ended December 31, 2019 was \$380,802. The fair value of options vested during 2019 was \$406,844. The weighted average grant date fair value of options granted during the year was \$0.07.

NOTE 8 – INCOME TAXES

The deferred tax assets account consists of the following for year ended December 31, 2019:

Net operating loss carryovers	\$ 26,199,000
Other accruals	223,000
Stock based compensation	88,000
Tax credit carryover	1,299,000
Fixed assets	<u>16,292,000</u>
	44,101,000
Less valuation allowance	<u>(44,101,000)</u>
Total	<u>\$ -</u>

EBR SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8 – INCOME TAXES (Continued)

As of December 31, 2019, the Company had federal net operating loss carryforwards of \$91.8 million and federal research and development tax credit carryforwards of \$1.4 million. If not utilized sooner, the federal net operating loss and tax credit carryforwards will begin to expire in 2023 and 2037, respectively. A net operating loss generated post 2017 tax years will not have an expiration date. As of December 31, 2019, the Company had state net operating loss carryforwards of \$70.1 million which will expire beginning in 2034, and state research and development tax credit carryforwards of \$0.6 million which do not expire. As of December 31, 2019, the Company has approximately \$7.7 million of Australia net operating loss carryforwards, which have an unlimited carryforward period.

In view of the uncertainty over the Company's ability to generate sufficient taxable income in future years to utilize the NOLs, a full valuation allowance of approximately \$44.1 has been recorded to offset the net deferred tax assets, resulting in no net deferred tax asset. The valuation allowance increased by approximately \$6.6 million during 2019.

The Company is subject to Federal income tax and franchise tax of the State of California. Federal income tax returns for the entity for the years ended after December 31, 2016 are open to audit by the Federal authorities. California State tax returns for the consolidated entity for the years ended after December 31, 2015, are open to audit by State authorities. The Company is also subject to income taxes in Australia, where the statute of limitations is generally four years.

Significant reconciling items between the U.S. federal income tax rates for 2019 to the Company's effective tax rate of zero includes state taxes and the valuation allowance for deferred tax assets.

No liability related to uncertain tax positions is recorded in the financial statements. The policy of the Company is to recognize any and all interest and penalties related to the underpayment or overpayment of income taxes as a component of income tax expense or benefit. Since inception, there have been no interest charges or penalties related to unrecognized tax benefits.

EBR SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 9 – COMMITMENTS AND CONTINGENCIES

Operating Lease

The Company is housed in one 15,237 square foot building under an 84-month operating lease, which commenced July 1, 2017 and expires on June 30, 2024. The monthly base rental is \$28,950 with 2% to 4% annual adjustments. A rent accrual has been established such that the expense impact to the income statement is consistently \$32,976 per month or \$395,712 annually throughout the agreement.

The minimum annual operating lease commitments and future minimum payments under this lease is as follows:

Years ending December 31,	
2020	371,712
2021	385,320
2022	396,882
2023	408,786
2024	<u>207,414</u>
Total minimum annual payments	<u>\$ 1,770,114</u>

Rental expense under operating lease agreements for the year ended December 31, 2019 was \$362,672.

Indemnification Agreements

The Company has indemnified its Board of Directors and officers, to the extent legally permissible, against all liabilities reasonably incurred in connection with any action in which such individual may be involved by reason of such individual being or having been a director or officer, other than liabilities arising from willful misconduct of the individual. The Company currently has directors and officers liability insurance. The Company believes the estimated fair value of any obligations resulting from these indemnification agreements is de minimis; therefore, the financial statements do not include a liability for any potential obligations at December 31, 2019.

EBR SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 10 – SUBSEQUENT EVENTS

On March 11, 2020, the World Health Organization declared the COVID-19 outbreak to be a pandemic. The disruption resulting from the COVID-19 pandemic is currently expected to be temporary, but there is considerable uncertainty around the duration and the Company expects this matter to negatively impact its operating results. However, the related financial impact and duration cannot be reasonably estimated at this time.

On March 27, 2020, the Coronavirus Aid, Relief, and Economic Security (CARES) Act was signed into law and includes changes to the Internal Revenue Code for refundable payroll tax credits, deferment of employer payments for social security tax, net operating loss carryback periods, alternative minimum tax credits, net interest deduction limitations, and depreciation of certain leasehold improvements. U.S. GAAP requires the effect of the CARES Act to be recognized in the period the law is enacted and, accordingly, the effect of the CARES Act is not recognized in these financial statements. The Company is currently evaluating the impact of the CARES Act.

On March 25, 2020, the Company entered into a new loan and security agreement with Silicon Valley Bank for borrowings up to \$9 million in three \$3 million tranches subject to achievement of certain performance milestones. The Company met the first two milestones and in March 2020 borrowed \$6,000,000 of which \$2,035,000 was used to pay off the Company's existing loan with Silicon Valley Bank. Advances under the loan and security agreement bear interest at the greater of 7.25% or 2.5% above the prime rate and are secured by substantially all assets of the Company, except for intellectual property. In connection with the agreement the Company issued two warrants each for the purchase 220,750 shares of common stock at an exercise price of \$.14 per share and a term of 10 years.

In March 2020, the COVID-19 crisis caused the Company to suspend enrollment in its SOLVE clinical trial. Accordingly, in April 2020 the Company did a restructuring resulting in a reduction in force of 21 employees.

In 2020, as part of the second tranche of the \$30 million financing discussed in Note 2 to the financial statements, the Company issued convertible notes totaling \$12.5 million with similar terms with the notes issued on August 26, 2019 (as discussed in Note 5 to the financial statements).

EBR SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 10 – SUBSEQUENT EVENTS (Continued)

In May 2020, the Small Business Administration approved the Company's application for the Payroll Protection Program of the CARES Act for \$1,253,525. This loan program provides critical funding in the form of forgivable loans to companies adversely economically impacted by the current global corona medical crisis. The loan under this program covers 2.5 times monthly "payroll costs" for the last 12 months up to an annual rate of \$100,000 per employee. Loans may not exceed \$10 million. The portion of the loan used to cover payroll costs, interest on mortgages, rent and utilities over an 8-week period from loan origination maybe forgiven. The amount of loan forgiveness is reduced by any reductions in employees' wages (in excess of 25%) or reduction in the number of employees, unless employer eliminates the salary reduction or rehires employees by June 30, 2020. Any loan amount not forgiven is carried forward as an ongoing loan amount with a maturity of 2 years and an interest rate of 1% subject to complete repayment. There is an initial payback deferral on the loan of 6 - 12 months.

In June 2020, the legislation was updated to allow current PPP borrowers to extend the eight-week period to 24 weeks. Borrowers can use the 24-week period to restore their workforce levels and wages to the pre-pandemic levels required for full forgiveness. The previous deadline for restoring workforce levels and wages as of June 30, 2020 was extended to December 31, 2020. The payroll expenditure requirement dropped from 75% to 60%. However, borrowers must spend at least 60% on payroll or none of the loan will be forgiven. Existing PPP loans can be extended up to 5 years if the lender and borrower agree. The interest rate remains at 1%. The updated legislation also allows businesses that took a PPP loan to also delay payment of their payroll taxes.

The Company has evaluated subsequent events for potential recognition and disclosure through October 2, 2020, the date the financial statements were available to be issued.