

Spectral Medical Inc.

Condensed Interim Consolidated Financial Statements

September 30, 2016

(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

September 30, 2016

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Spectral Medical Inc.

Condensed Interim Consolidated Statements of Financial Position
(Unaudited)

(in thousands of Canadian dollars)

	Notes	September 30 2016 \$	December 31 2015 \$
Assets			
Current assets			
Cash		7,180	6,369
Trade and other receivables		580	630
Inventories		384	243
Prepayments and other assets		173	141
		8,317	7,383
Non-current assets			
Property and equipment		718	717
Intangible asset		340	359
		1,058	1,076
Total assets		9,375	8,459
Liabilities			
Current liabilities			
Trade and other payables		2,511	2,850
Deferred revenue		70	176
Total liabilities		2,581	3,026
Equity			
Share capital	9	63,216	53,058
Contributed surplus		7,849	7,849
Other equity reserves		4,051	3,723
Deficit		(68,322)	(59,197)
Total equity		6,794	5,433
Total liabilities and equity		9,375	8,459

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 nine months ended September 30, 2016 and 2015
(Unaudited)

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

	Notes	Three months ended September 30		Nine months ended September 30	
		2016	2015	2016	2015
			\$		\$
Revenue		807	679	2,739	2,374
Expenses					
Changes in inventories of finished goods and work- in-process		106	28	189	108
Raw materials and consumables used		106	133	404	340
Employee benefits	9,12	896	846	3,106	2,756
Product development		-	16	67	16
Consulting and professional fees		1,689	1,451	6,299	4,693
Regulatory and investor relations		270	197	596	505
Travel and entertainment		172	329	642	721
Depreciation and amortization		53	43	144	130
Foreign exchange loss (gain)		29	8	59	(5)
Other expenses		137	141	414	393
		3,458	3,192	11,920	9,657
Operating loss		(2,651)	(2,513)	(9,181)	(7,283)
Finance income		18	20	56	68
Loss and comprehensive loss for the period		(2,633)	(2,493)	(9,125)	(7,215)
Basic and diluted loss per common share	10	(0.01)	(0.01)	(0.04)	(0.04)
Weighted average number of common shares outstanding	10	206,865,470	190,830,571	203,882,419	187,168,709

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 nine months ended September 30, 2016 and 2015
(Unaudited)

(in thousands of Canadian dollars)

	Notes	Issued capital Number	\$	Contributed surplus \$	Share-based compensation \$	Deficit \$	Total equity \$
Balance, January 1, 2015		179,737,241	46,879	7,849	3,542	(49,450)	8,820
Private placement	13	11,049,464	6,021	-	-	-	6,021
Shares repurchased under NCIB	9	(480,000)	(132)	-	-	(223)	(355)
Share options exercised	9	379,700	243	-	(104)	-	139
Loss and comprehensive loss for the period		-	-	-	-	(7,215)	(7,215)
Share-based compensation	9	-	-	-	274	-	274
Balance, September 30, 2015		190,686,405	53,011	7,849	3,712	(56,888)	7,684
Balance, January 1, 2016		190,771,405	53,058	7,849	3,723	(59,197)	5,433
Bought deal prospectus offering	13	15,106,804	9,399	-	-	-	9,399
Share options exercised	9	887,378	479	-	(200)	-	279
Broker warrants exercised		400,000	280	-	-	-	280
Loss and comprehensive loss for the period		-	-	-	-	(9,125)	(9,125)
Share-based compensation	9	-	-	-	528	-	528
Balance, September 30, 2016		207,165,587	63,216	7,849	4,051	(68,322)	6,794

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Spectral Medical Inc.

Condensed Interim Consolidated Statements of Cash Flows
For the nine months ended September 30, 2016 and 2015
(Unaudited)

(in thousands of Canadian dollars)

	Notes	Nine months ended 2016 \$	2015 \$
Cash flow provided by (used in)			
Operating activities			
Loss and comprehensive loss for the period		(9,125)	(7,215)
Adjustments for:			
Depreciation on property and equipment		125	112
Amortization of intangible asset		19	18
Share-based compensation	9	528	274
Loss on disposal of property and equipment		6	-
Changes in items of working capital:			
Trade and other receivables		50	(102)
Inventories		(141)	(89)
Prepayments and other assets		(32)	(278)
Trade and other payables		(339)	(78)
Deferred revenue		(106)	(80)
Net cash used in operating activities		(9,015)	(7,438)
Investing activities			
Property and equipment expenditures		(132)	(17)
Net cash used in investing activities		(132)	(17)
Financing activities			
Bought deal prospectus offering	13	9,399	-
Private placement	13	-	6,021
Share options exercised	9	279	139
Broker warrants exercised		280	-
Shares repurchased under NCIB	9	-	(355)
Net cash provided by financing activities		9,958	5,805
Increase(decrease) in cash		811	(1,650)
Cash, beginning of period		6,369	10,054
Cash, end of period		7,180	8,404

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Notes to the Condensed Interim Consolidated Financial Statements
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(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 nine months ended September 30, 2016, 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, 2015, which have been prepared in accordance with IFRS. These condensed interim consolidated financial statements were approved by the Board of Directors for issue on November 10, 2016.

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, 2015.

5. Accounting standards adopted in the current period

The following amendment has been adopted by the Company for the financial year beginning on January 1, 2016:

Amendment to IAS 1, *Presentation of Financial Statements*: This standard was amended to clarify guidance on materiality and aggregation, the presentation of subtotals, the structure of financial statements, and the disclosure of accounting policies. The amendment is required for

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years beginning on or after January 1, 2016. The adoption of the amendment to IAS 1 will not have any material impact on the Company's financial statements.

6. 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.

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, 2015. 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 \$2,511 as at September 30, 2016 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 EUPHRATES trial

Trial enrolment was completed in June 2016, with a total of 450 evaluable patients.

On October 3, 2016 the Company announced top line trial results, which did not demonstrate a statistically significant reduction in 28 day mortality in the targeted patient population with this sample size.

The Company is now undertaking a detailed analysis and evaluation of the entire trial data base, which process is expected to be completed and a pre submission meeting held with the FDA by mid-Q1 2017.

Future commitments for trial expenses, relate primarily to the statistical analysis and clinical site closeout costs. As of September 30, 2016, they are expected to be as follows:

	2016	2017
	\$	\$
Trial expenses	478	145

- 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 September 30, 2016 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

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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 September 30, 2016.

- iii. On December 15, 2014, the Company announced that the TSX approved its notice of intention to make a NCIB for its outstanding Shares. Pursuant to the notice, the Company was able to 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.

During the nine month period ended September 30, 2015, the Company repurchased 480,000 Shares under this NCIB for \$355. All Shares purchased were cancelled.

- iv. 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 year, the Company granted the following share options to directors, officers, employees and consultants at the discretion of the Board of Directors.

2016			2015		
Date	Number of share options	Exercise price	Date	Number of share options	Exercise price
February 1, 2016	1,420,000	\$0.73	January 22, 2015	1,250,000	\$0.38
March 29, 2016	180,000	\$0.76	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 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.

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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:

2015

Grant date	Risk-free interest rate	Expected life	Annualized volatility	Dividend rate	Grant date share price	Share option fair value
January 22, 2015	0.84%	5 years	65.89%	0%	\$0.365	\$0.198
March 24, 2015	0.72%	5 years	75.12%	0%	\$0.780	\$0.496

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%	\$0.720	\$0.429
March 29, 2016	0.51%	2 years	64.39%	0%	\$0.760	\$0.269

2016

2015

	Weighted average exercise price per share \$	Share options		Weighted average exercise price per share \$	Share options	
		All	Key		All	Key
		optionees	management		optionees	management
January 1	0.37	5,086,500	4,143,500	0.37	5,566,000	4,513,500
Granted	0.73	1,600,000	950,000	0.40	1,350,000	950,000
Exercised	0.31	(887,378)	(730,000)	0.37	(379,700)	(70,000)
Expired	0.32	(200,000)	(200,000)	0.42	(1,325,050)	(1,250,000)
Forfeited/cancelled	0.73	(6,250)	-	0.38	(39,750)	-
Balance, September 30	0.48	5,592,872	4,163,500	0.36	5,171,500	4,143,500

Of the 5,592,872 outstanding share options (2015: 5,171,500), 4,404,410 share options (2015: 4,068,030) 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:

	2016 \$	2015 \$
Numerator for basic and diluted loss per common share available to common shareholders	(9,125)	(7,215)
Denominator for basic and diluted loss per common share	203,882,419	187,168,719
Basic and diluted loss per common share	(0.04)	(0.04)

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

	2016		2015	
	Number of Common Shares	Weighted average common shares-basic and diluted	Number of Common Shares	Weighted average common shares-basic and diluted
Balance, January 1	190,771,405	190,771,405	179,737,241	179,737,241
Bought deal prospectus offering	15,106,804	12,387,555	-	-
Private placement	-	-	11,049,464	7,366,309
Shares repurchased under NCIB	-	-	(480,000)	(142,651)
Share options exercised	887,378	682,583	379,700	207,810
Warrants exercised	400,000	40,876	-	-
Balance, September 30	207,165,587	203,882,419	190,686,405	187,168,709

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11. The EUPHRATES trial

The Company's clinical development program continues to be 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:

	Three months ended September 30		Nine months ended September 30	
	2016	2015	2016	2015
		\$		\$
Program management	1,028	1,045	2,987	2,699
Program oversight	183	188	488	409
Clinical site costs	167	380	2,202	1,587
Diagnostic supply and training	30	83	248	239
Employee benefits	111	126	343	361
Consultants	36	14	101	40
Total EUPHRATES	1,555	1,836	6,369	5,335

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 \$39,228.

12. Employee benefits

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

	Three months ended September 30 2016		Nine months ended September 30 2016	
	All employees	Key management	All employees	Key management
		\$		\$
Salaries	597	297	1,858	935
Bonuses	95	90	275	270
Short term employee benefits	77	25	239	81
Directors' fees	56	56	191	191
Share-based compensation	69	45	528	329
Other	2	-	15	2
	896	513	3,106	1,808

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

	Three months ended September 30 2015		Nine months ended September 30 2015	
	\$		\$	
	All employees	Key management	All employees	Key management
Salaries	578	290	1,762	898
Bonuses	90	90	275	270
Short term employee benefits	71	25	222	75
Directors' fees	59	59	168	168
Share-based compensation	46	28	274	182
Other	2	-	55	1
	846	492	2,756	1,594

Executive employment agreements allow for additional payments of approximately \$1,752 if the individuals are terminated without cause and approximately \$2,215 in the event of a change in control.

13. Financings

i. 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. 400,000 broker warrants were exercised in September, 2016 for total proceeds of \$280.

ii. Private placements

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.

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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 is being used to fund its EUPHRATES trial and for working capital and general corporate purposes.

The Tranche "B" component of the private placement was completed on April 1, 2015. Toray purchased 9,041,592 Shares at a subscription price of \$0.553 per common 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 connection with the Toray offering, Birch Hill exercised their anti-dilution rights and acquired 2,007,872 Shares at the subscription price of \$0.553 per common share, for aggregate gross proceeds of \$1,110.

In total, the Company issued 11,049,464 Shares for aggregate gross proceeds of \$6,110. The Company received net proceeds of \$6,021 which is being used to fund its EUPHRATES trial and for working capital and general corporate purposes.

14. Related party transactions

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

Toray holds 45,630,105 Shares of the Company as at September 30, 2016, representing approximately 22.0% (2015 – 22.4%) 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 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:

	Three months ended September 30		Nine months ended September 30	
	2016	2015	2016	2015
		\$		\$
Revenue				
Toray Medical Co., Ltd.	159	-	245	98
Toray International Italy S.r.l.	-	-	-	64
Purchases				
Toray Industries, Inc.	-	-	101	-
Toray International America Inc.	-	-	131	56
Reimbursement of expenses				
Toray Industries, Inc.	-	-	-	101

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	Three months ended September 30		Nine months ended September 30	
	2016	2015	2016	2015
		\$		\$
Due from (to)				
Toray Medical Co., Ltd.			-	-
Toray Industries, Inc.			-	-
Toray International America Inc.			-	(37)

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 September 30, 2016 representing approximately a 16.2% (2015 – 17.3%) 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.