

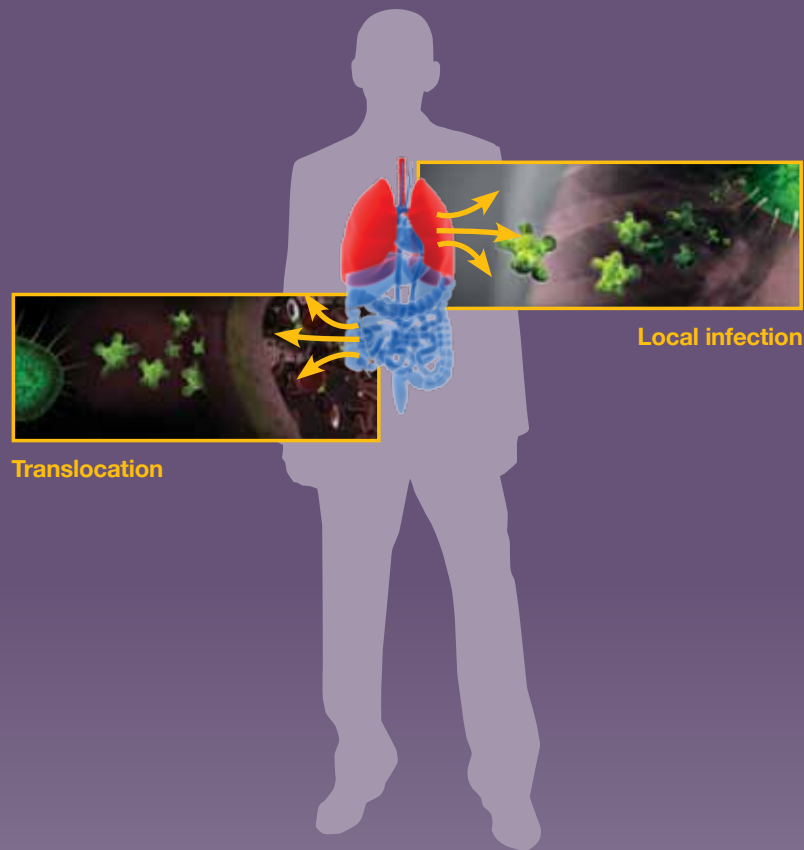


# Winning the battle against sepsis



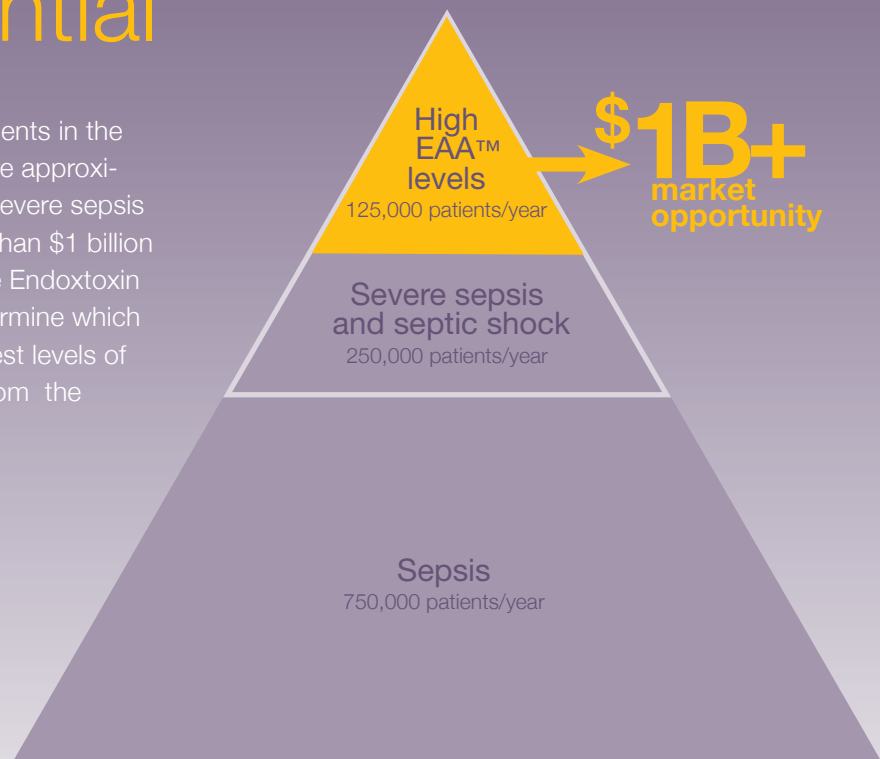
# Endotoxin: A major cause of sepsis

Most sepsis is caused by endotoxemia — endotoxin moving into the bloodstream. Endotoxin is a component of all gram negative bacteria and is released when this bacteria is replicating or dying. Sepsis results in almost 250,000 deaths in the U.S. each year and costs the U.S. healthcare system more than \$17 billion annually.



## Market potential

Sepsis affects approximately 750,000 patients in the U.S. each year. Of these patients, there are approximately 250,000 patients diagnosed with severe sepsis and septic shock, representing a greater than \$1 billion market opportunity for Spectral. Using the Endotoxin Activity Assay (EAA™), clinicians can determine which patients with severe sepsis have the highest levels of endotoxin and are most likely to benefit from the Toraymyxin column.



# The first theranostic trial in sepsis

## EAA™

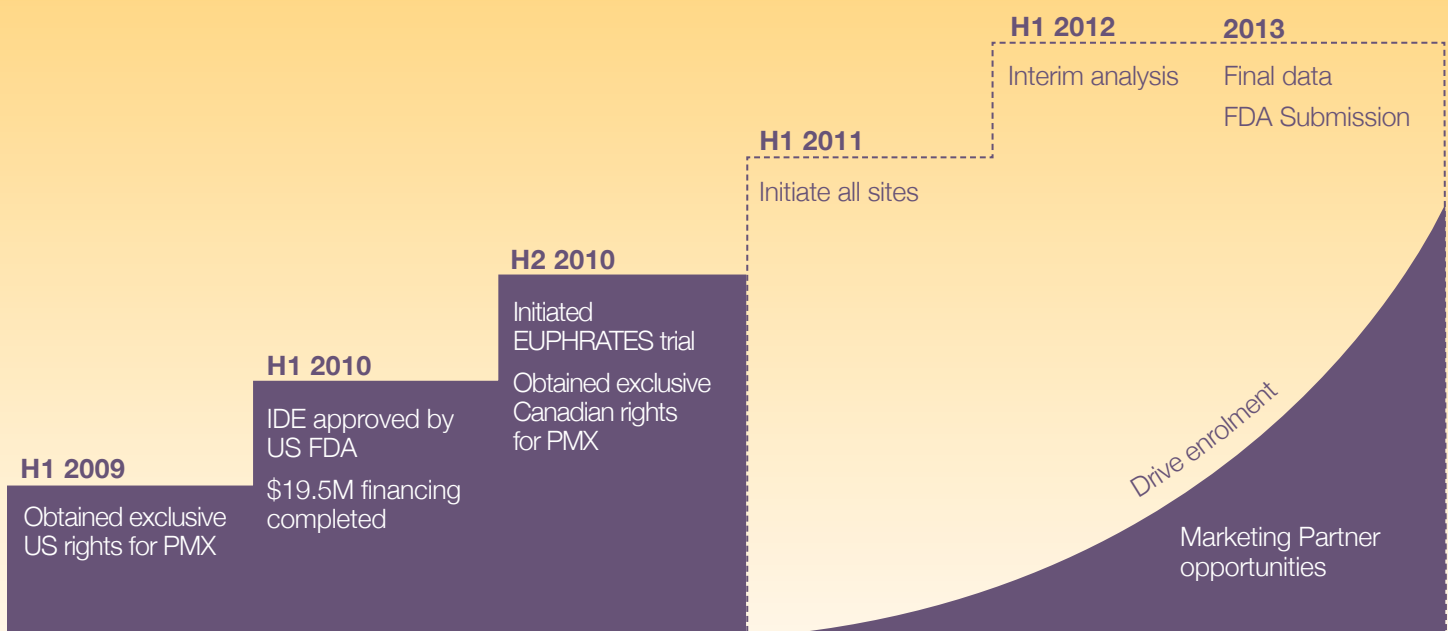
The only FDA cleared test for detection of endotoxin



## Toraymyxin (PMX)

- Therapeutic column that removes endotoxin from the bloodstream
- Marketed since 1994
- More than 80,000 patients treated safely
- More than 50 published papers demonstrating its mortality benefits

## Milestones



# Letter to shareholders

Going into 2010, Spectral set its sights on the achievement of three key goals for the fiscal year:

- Initiate our U.S. pivotal trial for Toraymyxin, a therapeutic hemoperfusion device that removes endotoxin — one of the major causes of sepsis - from the bloodstream in patients with severe sepsis
- Expand the acceptance of our theranostics approach to the treatment of sepsis, utilizing the EAA™ diagnostic and the Toraymyxin therapeutic device, among key opinion leaders and clinicians worldwide in the field of sepsis
- Close out 2010 with the financial stability to continue moving this important Phase III asset forward to completion

We achieved all three objectives in 2010, which puts us in position to have an exciting 2011.

The initiation of our Phase III EUPHRATES trial in 2010 was a crucial milestone for Spectral and brought us closer to providing U.S. patients with a novel therapeutic device that has the potential to effectively treat severe sepsis.

At present, there are few therapeutic treatment options available for the more than 250,000 patients diagnosed with severe sepsis in the U.S. each year. This disease remains a leading cause of mortality and we are focusing our efforts on making a significant contribution towards treating this condition.

Toraymyxin has been used safely on more than 80,000 patients worldwide and, when guided by our EAA™ diagnostic, has the potential to address this large unmet medical need, which is valued at more than \$1 billion annually in the U.S.

We anticipate that all 15 clinical sites that are part of the EUPHRATES trial will be enrolling patients in the first half of 2011, and we are currently on track to carry out an interim analysis on the trial's data by the end of the first half of 2012.

To date, there have been more than 50 published papers demonstrating Toraymyxin's significant mortality benefits. We added to that body of work in 2010 by creating more academic partnerships that leveraged our knowledge and leadership in the field of sepsis. As a result, additional clinical papers about important findings in the area of endotoxin and its role in sepsis were published this past year. This new data supports the potential positive impact of Toraymyxin, particularly when guided by our EAA™ diagnostic, which is the focus of our U.S. pivotal trial.

Early in 2010, we solidified our cash position through the closure of a private placement for \$19.5 million. We concluded 2010 with \$15.3 million in cash and short term investments, which provides us with a financial runway well into 2012.

We feel we are in position to have a successful 2011. We are effectively moving a Phase III asset forward in a potentially lucrative therapeutic area, and we are on solid financial ground.

I would like to thank the staff and management team for their effort and diligence this past year. Thanks also to the Board of Directors for the ongoing hard work and guidance. Finally, I would like to thank both our long term and new shareholders for their support. It is a very exciting time for Spectral and I look forward to updating you on our progress throughout the year.

Sincerely,



Dr. Paul Walker  
President & CEO

March 10, 2011

**MANAGEMENT'S DISCUSSION & ANALYSIS**  
**(All figures are expressed in thousands of Canadian dollars)**

This Management's Discussion & Analysis ("MD&A") for the year ended December 31, 2010 has been prepared to help investors understand the financial performance of the Company in the broader context of the Company's strategic direction, the risks and opportunities as understood by management, and the key success factors that are relevant to the Company's performance. Management has prepared this document in conjunction with its broader responsibilities for the accuracy and reliability of the financial statements, as well as the development and maintenance of appropriate information systems and internal controls to ensure that the financial information is complete and reliable. The Finance and Audit Committee of the Board of Directors has reviewed this document and all other publicly reported financial information for integrity, usefulness, reliability and consistency.

The following discussion should be read in conjunction with the financial statements for the year ended December 31, 2010, and for the year ended December 31, 2009.

**FORWARD LOOKING STATEMENTS**

Certain statements contained in this MD&A constitute forward-looking information within the meaning of securities laws. Forward-looking information may relate to our future outlook and anticipated events or results and may include statements regarding our future financial position, business strategy, budgets, litigation, projected costs, capital expenditures, financial results, taxes and plans and objectives. In some cases, forward-looking information can be identified by terms such as "may", "will", "should", "expect", "plan", "anticipate", "believe", "intend", "estimate", "predict", "potential", "continue" or other similar expressions concerning matters that are not historical facts. These statements are based on certain factors and assumptions regarding, among other things, expected growth, results of operations, performance and business prospects and opportunities. While we consider these assumptions to be reasonable based on information currently available to us, they may prove to be incorrect. Forward looking-information is also subject to certain factors, including risks and uncertainties that could cause actual results to differ materially from what we currently expect. These factors include, among other things, the availability of funds and resources to pursue development projects, the successful and timely completion of clinical studies, and the ability of Spectral Diagnostics Inc. to take advantage of business opportunities, the granting of necessary approvals by regulatory authorities as well as general economic, market and business conditions. For more exhaustive information on these risks and uncertainties you should refer to our most recently filed annual information form which is available at [www.sedar.com](http://www.sedar.com). Forward-looking information contained in this MD&A is based on our current estimates, expectations and projections, which we believe are reasonable as of the current date. You should not place undue importance on forward-looking information and should not rely upon this information as of any other date. While we may elect to, we are under no obligation and do not undertake to update this information at any particular time.

**DISCLOSURE CONTROLS AND INTERNAL CONTROLS**

The Company's management maintains a system of disclosure controls and procedures to provide reasonable assurance that material information is made known, and has designed internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Generally Accepted Accounting Principles ("GAAP"). As at December 31, 2010, management has evaluated the effectiveness of its disclosure controls and procedures, and of its internal controls over financial reporting, and has concluded that such processes are operating effectively. There has been no change during the Company's most recent interim period in the internal controls over financial reporting.

Dr. Paul M. Walker, Chief Executive Officer, and Mr. Anthony Businskis, Chief Financial Officer, in accordance with Multilateral Instrument NI 52-109, have also both certified that:

- They have reviewed the financial statements and this MD&A (“the Filings”);
- Based on their knowledge, these Filings do not contain any untrue fact or omit a material fact;
- The Filings present fairly the financial position, results of the operations and cash flows of the Company;
- They have designed such disclosure controls and procedures, or caused them to be designed under their supervision, to provide reasonable assurance that material information relating to the Company is made known to them by others within the Company, particularly during the period in which the annual filings are being prepared;
- They have designed such internal controls over financial reporting, or caused them to be designed under their supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP; and
- They have evaluated effectiveness of disclosure controls and procedures as of the end of the period covered by the annual filings and have caused the Company to disclose in the annual MD&A their conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by the annual filings based on such evaluation.

This document and the related financial statements can also be viewed on the Company’s website at [www.spectraldx.com](http://www.spectraldx.com) and at [www.sedar.com](http://www.sedar.com). The Company’s Annual Information Form and Management Information Circular are also available on these websites.

## **INTRODUCTION**

Spectral Diagnostics Inc. ("Spectral" or the "Company") is strategically focused on the development and commercialization of a treatment for severe sepsis utilizing its Endotoxin Activity Assay (EAA™) and the Toraymyxin therapeutic. If approved, this will be the first theranostics product, a targeted therapy guided by a specific diagnostic, in the area of sepsis. The Company also manufactures and sells certain proprietary reagents.

### **EAA™**

Spectral has pioneered the development of biochemical markers for the clinical syndrome known as "severe sepsis". In 2003, the Company achieved US Federal Drug Administration ("FDA"), Health Canada and European CE clearance of the Endotoxin Activity Assay ("EAA™") for the first recognized rapid test for the risk of developing sepsis in the Intensive Care Unit ("ICU"). In North America alone three million patients are at risk for developing sepsis annually. Between 30% and 50% of patients with severe sepsis die in the ICU. Earlier identification and treatment of patients at risk for sepsis reduces mortality and saves significant cost by reducing the length of stay in the ICU and helping to guide therapeutic interventions. Spectral's EAA™ endotoxin measurement is the only FDA cleared diagnostic for this indication currently on the market.

### **TORAYMYXIN**

Toraymyxin is a therapeutic hemoperfusion device that removes endotoxin from the bloodstream. Toraymyxin has been used in more than 80,000 patients globally and has demonstrated in clinical trials that it safely and effectively removes endotoxin and reduces mortality in patients with severe sepsis.

Results of a randomized controlled trial (the EUPHAS trial) were recently published in the *Journal of the American Medical Association* (JAMA, 2009; Vol. 301 No. 23, 2445-2452). The results demonstrated that when Toraymyxin is added to conventional therapy, there is significantly improved hemodynamics and organ function, and reduced 28-day mortality in patients with severe sepsis and septic shock in comparison to those patients in the conventional therapy group.

### **PROPRIETARY REAGENTS**

Since 1997, the Company has initiated certain programs to market technologies developed in-house in conjunction with its core diagnostic business. Spectral develops, produces and markets recombinant proteins, antibodies and calibrators. These materials are sold for use in research and development as well as in products manufactured by other diagnostic companies.

In 2000, the Company completed non-exclusive license and supply agreements with Beckman Coulter for the access and use of the Company's proprietary Troponin I technologies. Similar agreements were signed with Abbott and BioMerieux in 2002, and Bio-Rad 2007. Royalty revenue is earned from these license arrangements based on a percentage of end user sales of Troponin I.

### **CLINICAL DEVELOPMENT**

The Company's only clinical development program is focused on obtaining US FDA approval for Toraymyxin.

On March 6, 2009, Spectral signed a license agreement with Toray Industries, Inc. of Japan granting Spectral the exclusive development and commercial rights in the US for Toraymyxin, a therapeutic device for the treatment of sepsis that removes endotoxin from the bloodstream. Under the terms of the agreement, Spectral is seeking FDA approval for Toraymyxin and intends to commercialize the product, together with its Endotoxin Activity Assay (EAA™), the only FDA cleared diagnostic for the measurement of endotoxin.

On February 26, 2010, the Company received final approval of its Investigation Device Exemption (“IDE”) from the US FDA, which permits the Company to conduct a pivotal trial for Toraymyxin (the EUPHRATES trial) in the United States.

On March 2, 2010, the Company completed a private placement financing for aggregate gross proceeds of \$19,500. Net proceeds from the financing, after related costs, were \$17,608. At December 31, 2010 approximately \$14,900 of these funds have been invested in a low risk guaranteed investment certificate and money market investment funds. These funds will be utilized primarily for the regulatory approval and initial commercial development of Toraymyxin in the US market.

In October, 2010, the Company announced the initiation of its EUPHRATES trial (Evaluating the Use of Polymyxin B Hemoperfusion in a Randomized controlled trial of adults Treated for Endotoxemia and Septic shock) in the United States comparing standard of care versus Toraymyxin plus standard of care. All clinical trial sites are projected to be fully operational in the first half of 2011. The estimated length of the trial is up to 30 months after all sites are operational, with an interim analysis planned at the midpoint of the trial. The trial is expected to enroll approximately 360 patients at 15 sites throughout the US, with 28 day mortality being the primary end point.

In November, 2010, the Company signed a long-term, exclusive distribution agreement with Toray Industries, Inc. and Toray Medical Co., Ltd. of Japan (collectively “Toray”) to market and sell Toraymyxin in Canada. Both the Toraymyxin product and Spectral’s EAA™ diagnostic are already approved for sale by Health Canada. The Company is developing commercial plans for the Canadian market.

Toraymyxin is marketed in Japan and Europe and has been used to treat more than 80,000 sepsis patients safely and effectively. Spectral’s EAA™ can identify patients that will benefit from Toraymyxin and monitor the effects of the treatment. This combination of the EAA™ diagnostic and the Toraymyxin therapeutic has been utilized by clinicians in Europe since November 2007 and has demonstrated a significant reduction in mortality. The market opportunity for Spectral is large, as the combined diagnostic and therapeutic product is expected to fulfill a major unmet need for the approximately 250,000 patients who develop severe sepsis or septic shock in the US each year. Over half of these patients have highly elevated levels of endotoxin. The US market potential for this treatment is estimated at over \$ 1 billion.

## **OPERATIONS**

Spectral’s organizational structure for the year ended December 31, 2010, and for the year ended December 31, 2009, includes the operational areas of manufacturing, clinical and business development, and general and administrative support for its core products.

In 2010, the Company’s activities were focused on implementation of the Euphrates trial in the US for the first theranostic in the area of sepsis, combining Spectral’s EAA™ diagnostic for the measurement of endotoxin with a targeted therapy (Toraymyxin) that removes it from the bloodstream.

The Company also continues to sell its EAA™ diagnostic and its proprietary reagents under the terms of existing commercial arrangements.

## OPERATING RESULTS

### Selected Annual Information

(Expressed in thousands of Canadian dollars, except share and share data.)

	Year Ended December 31, 2010	Year Ended December 31, 2009	Year Ended December 31, 2008
Sales	\$ 2,821	\$ 3,283	\$ 3,011
Loss and comprehensive loss	\$ (6,567)	\$ (2,764)	\$ (1,502)
Loss per common share			
-basic and fully diluted	\$ (0.10)	\$ (0.11)	\$ (0.06)
Weighted average number of commons shares outstanding			
-basic and fully diluted	67,210,554	24,118,424	24,118,424
Total assets	\$ 17,295	\$ 5,032	\$ 7,085
Total long term liabilities	Nil	Nil	\$ 2,172

The total number of shares outstanding as of the date of this Management's Discussion & Analysis is 80,550,061.

### SALES

Sales for the year ended December 31, 2010 were \$2,821, compared to \$3,283 for the year ended December 31, 2009.

In 2010, sales of the Company's EAA™ product decreased to \$618, compared to \$772 in the prior year, due mainly to the expiry of certain distribution agreements. EAA™ sales are again expected to decline in 2011 due to the timing of the renegotiation of certain distribution contracts and to the Company's focus on the clinical development of Toraymyxin in the very large US market.

Reagent sales of \$313 decreased slightly from the prior year as a result of the impact of the strengthening Canadian dollar compared to the US currency. Reagent sales in 2011 are projected to remain consistent with 2010 levels.

Royalty revenues of \$1,891 related to the Company's Troponin I technology, were 13% lower than the \$2,179 of royalty revenues in 2009, again primarily due to the impact of the strengthening Canadian dollar. Royalty revenues in 2011 are expected to approximate 2010 levels.

### GROSS MARGIN AND EXPENSES

The Company continues to maintain a low cost operating structure. This has resulted in the achievement of gross margins of approximately 76% for the year ended December 31, 2010 and 75% for the year ended December 31, 2009. The Company expects no material increase in operating costs for its base business in 2011.

The \$453 increase in selling, general and administrative expenses in 2010, to \$4,060, is due to expanded development activities for Toraymyxin and EAA™ in the US and Europe.

Clinical trial costs were \$ 2,053 in 2010, compared to clinical trial start up expenses of \$ 503 in 2009. Clinical trial costs that were incurred in 2009 and through the first quarter of 2010 were primarily related to consulting costs associated with the IDE approval. Commencing April 2010, these costs included clinical site start ups, contract research organization (CRO) costs and ongoing trial expenses. Clinical trial costs are estimated at approximately \$4,000 in 2011.

The \$1,000 of service fees was paid to Medwell Capital ("Medwell"), formerly BioMS Medical Corp., pursuant to a three year, \$3,000 contract that became effective January 1, 2010. Under the terms of this contract, Medwell provides consulting services and resources to Spectral, as required, to assist the Company in the regulatory and commercialization process for Toraymyxin.

The foreign exchange loss of \$64 (2009 - \$128) was due to the continued strengthening Canadian dollar compared to the US dollar during the year. A significant portion of the Company's royalty revenues is, denominated in US currency. In 2011, exposure to foreign exchange fluctuations in revenues will be mitigated by clinical trial expenses, which are also denominated in US currency.

Stock compensation expense was \$792 in 2010, compared to \$78 in 2009. 1,950,000 stock options were granted to directors, officers and employees during 2010, compared to 365,000 stock options granted during the year ended December 31, 2009.

Research and development costs for the year ended December 31, 2010 amounted to \$24, compared to \$68 in 2009. The Company does not expect to incur any significant research and development expenses related to its existing business, or to receive any significant investment tax credit refunds, going forward.

Interest expense of \$164 in 2010 and 2009 is comprised of the amortization of a \$660 discount on the convertible notes payable that were due on December 31, 2010. The notes were fully repaid, settled and cancelled during the year as follows:

On March 2, 2010, the Company issued 2,890,625 Common Shares to GrowthWorks Canadian Fund Ltd., at a deemed price of \$0.40 per Common Share as full repayment and final settlement of a non-interest bearing, unsecured convertible promissory note in the principal amount of \$1,156 dated June 19, 2006. Following conversion, the note was cancelled.

On December 31, 2010, the Company issued 4,648,512 common shares to three note holders at a conversion price of approximately \$0.29 per common share, as full repayment and final settlement of the remaining notes in the principal amount of \$1,344. The conversion was in accordance with the terms of the notes. Following conversion, the notes were cancelled.

Other net investment income of \$ 87 includes interest earned on a 180 day non redeemable GIC and a premium money market account. In 2009, other investment loss included a loss on the sale of the Company's then bond portfolio of \$76.

#### **SELECTED QUARTERLY FINANCIAL DATA**

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

The following information summarizes quarterly financial information for the year ended December 31, 2010 and the comparative year ended December 31, 2009:

#### **Year ended December 31, 2010**

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total
Sales	748	678	722	673	2,821
Loss and comprehensive loss	(1,943)	(1,270)	(1,290)	(2,064)	(6,567)
Loss per common share (basic and fully diluted)	(0.05)	(0.02)	(0.02)	(0.03)	(0.10)
Weighted average number of common shares outstanding (basic and fully diluted)	40,793,181	75,822,318	75,844,484	75,901,549	67,210,554

**Year ended December 31, 2009**

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total
Sales	842	776	815	850	3,283
Loss and comprehensive loss	(404)	(701)	(429)	(1,230)	(2,764)
Loss per common share (basic and fully diluted)	(0.02)	(0.03)	(0.01)	(0.05)	(0.11)
Weighted average number of common shares outstanding (basic and fully diluted)	24,118,424	24,118,424	24,118,424	24,118,424	24,118,424

**FINANCING AND CONVERTIBLE NOTES PAYABLE**

On March 2, 2010, the Company completed a private placement financing whereby the Company issued 48,750,000 Units of the Company (the "Units"), at a price of \$0.40 per Unit, to a group of investors for aggregate gross proceeds of \$19,500. Each Unit consists of one common share of the Company ("Common Share") and one half of one Common Share purchase warrant (each whole Common Share purchase warrant, a "Warrant") entitling the holder thereof to acquire one Common Share at a price of \$0.60 per Common Share for a period of four years from Closing.

In connection with the Financing, and as partial consideration for services performed, at Closing, the Company also issued broker warrants to Desjardins Securities Inc., who acted as agent for the Financing, which will entitle them to acquire 1,462,500 Common Shares at an exercise price of \$0.40 per Common Share, and a further 731,250 Common Shares at an exercise price of \$0.60 per Common Share, in each case, for a period of four years from Closing.

The Company has also issued 2,890,625 Common Shares to GrowthWorks Canadian Fund Ltd. ("GrowthWorks"), at a deemed price of \$0.40 per Common Share as full repayment and final settlement of a non-interest bearing, unsecured convertible promissory note in the principal amount of \$1,156 dated June 19, 2006.

On December 31, 2010, the Company issued a total of 4,648,512 common shares to three noteholders, including GrowthWorks, at a conversion price of approximately \$0.29 per common share, as full repayment and final settlement of the remaining notes in the principal amount of \$1,344. The conversion was in accordance with the terms of the notes. Following the conversion, the notes were cancelled.

**BALANCE SHEET, FINANCIAL CONDITION AND LIQUIDITY**

Cash and short term investments of \$10,311 as at December 31, 2010 (December 31, 2009 - \$2,944) increased by \$7,367. This increase is attributable to the following cash utilization:

Net proceeds of financing	\$17,608
Short term investments	(5,021)
Operating losses	(4,836)
Working capital	359
Payment of Toraymyxin license fee	(502)
Other (net)	(241)
	<u>\$7,367</u>

In 2011, the Company's existing commercial business is expected to operate at a small loss, without significant utilization of cash reserves. Costs of the EUPHRATES clinical trial will be adequately funded from the \$19,500 of capital raised in 2010. Other funds, if necessary for new commercial opportunities, will be raised in capital markets as required. Management believes it will have sufficient cash to fund the trial for its existing commercial operations, and to successfully implement its strategy to bring a combined diagnostic/therapeutic treatment for severe sepsis to the North American market.

## **OUTLOOK**

The Company will continue to operate pursuant to its existing commercial arrangements for EAA™ and its proprietary biological reagents in 2011. The strategic focus for the next several years will be on the successful implementation of the EUPHRATES trial, with all clinical sites to be enrolling patients by the first half of 2011 and interim results expected in the first half of 2012. Management expects that the Company will have sufficient funds for these activities.

## **BUSINESS RISKS**

The Company's operations are exposed to a variety of risk factors inherent in new product development. The Company's short operating history in its new endeavours makes prediction of future operating results difficult. Actual future results may differ significantly from those projected in any forward-looking statements. Key business risks for the Company are detailed in its most recent Annual Information Form which is available at [www.sedar.com](http://www.sedar.com). Some of the major risk factors are outlined below:

### **CLINICAL DEVELOPMENT**

The outcome of any clinical trial is uncertain and subject to various risks, including the rate of patient enrolment, trial costs, regulatory issues, and safety concerns. The Company's EUPHRATES trial carries similar risks, including the possibility of clinical failure to show efficacy or safety, a requirement to potentially increase the number of patients and the possibility that the product may not be approved. A material change in any of these items could have a significant adverse impact on the operations of the Company.

### **SALES**

- delays or difficulties encountered in obtaining regulatory approval of new products
- effectiveness of the launch of the EAA™ products and their market acceptance
- reliance on key distributors to market and sell products in the US and international markets

### **MANUFACTURING ACTIVITIES**

- limited internal manufacturing capability
- ability to outsource to third party manufacturers
- compliance of manufacturing facilities with regulatory requirements

### **GENERAL BUSINESS RISK FACTORS**

- ability to generate positive cash flows from operations
- retention and attraction of key management and other experienced personnel
- development of appropriate strategies to deal with the competitive market

## **EFFECTS OF FINANCIAL MARKET RISK**

A significant portion of the Company's revenues are denominated in US dollars and Euros and subject to fluctuation in exchange rates. There is a risk that significant fluctuations in exchange rates may impact the Company's profitability. The Company does not use derivative financial instruments for speculative or trading purposes.

The primary objective of the Company's investment policy is the protection of principal and, accordingly, the Company invests in high-grade government and corporate securities with varying maturities.

## **LITIGATION AND PATENTED TECHNOLOGIES**

The Company, from time to time, is involved in various claims and legal proceedings of a nature considered normal to its business. No provision in respect of any such matters has been made in the Company's financial statements and there are no current claims or legal proceedings outstanding.

The biotechnology industry is heavily reliant on patented technology and, by nature, litigious. Products and processes may be subject to claims of infringement upon the patents of others. The Company follows a patent program to protect its technology and takes precautions to avoid infringement against the technology of others. However, by the nature of the industry, the Company could be approached by patent holders and, if their claims were substantiated, the Company may be required to access such technology by way of license in order to continue operations. Conversely, the Company intends to protect its technologies and may be required to take necessary action to ensure that it will be fairly compensated for any infringement by others.

## **CRITICAL ACCOUNTING POLICIES**

The financial statements of Spectral are prepared within a framework of GAAP selected by management and approved by the Finance and Audit Committee of the Board of Directors. These policies are set out in note 2 to the financial statements. Certain policies are more significant than others and are, therefore, considered critical accounting policies. Accounting policies are considered to be critical if they rely on a substantial amount of judgment in their application or if they result from a choice between accounting alternatives and that choice has a material impact on the reported results or financial position. The policies identified as critical to Spectral are discussed below.

In addition to accounting policies, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. The most significant estimates are related to the recoverability of purchased technology and licences, property, plant and equipment and valuation assumptions related to stock-based compensation. Actual results could differ from those estimates.

## **INTERNATIONAL FINANCIAL REPORTING STANDARDS**

In February 2008, the CICA announced that Canadian GAAP for publicly accountable enterprises will be replaced by International Financial Reporting Standards ("IFRS") for fiscal years beginning on or after January 1, 2011. Accordingly, the conversion from Canadian GAAP to IFRS will be applicable to the Company's reporting for the first quarter of 2011, for which the current and comparative information will be prepared under IFRS. The Company has determined that the transition to IFRS will not have a material impact on its financial results, internal control over financial reporting, disclosure controls and procedures and business activities. As part of its IFRS implementation plan, the Company continues to review the impact on its disclosure controls and procedures and internal control over financial reporting.

The Company has established an IFRS changeover plan consisting of three phases.

- Diagnostic review phase- consisted of a high level impact assessment to identify key areas of changes. This was completed in 2009 and the results of the review were presented to the Board of Directors.
- Impact analysis, evaluation and design phase- develop policy alternatives, draft financial statement content and determine changes to existing accounting policies, information systems and business processes. This was completed in the third quarter of 2010.
- Implementation and review phase – implement and approve changes to accounting policies, information systems, business processes and training programs, develop IFRS compliant financial statements and obtain audit committee approval. The Company is currently in this phase of the IFRS changeover plan.

The following table summarizes the key elements of the Company's plan for transitioning to IFRS and the progress made against each activity:

<b>IFRS Impact Area</b>	<b>Key Activities</b>	<b>Current Status</b>
Accounting policies and procedures	<ul style="list-style-type: none"> <li>• Identify differences between Canadian GAAP and IFRS accounting policies that impact the Company</li> <li>• Selection of IFRS 1 accounting policy choices</li> <li>• Analyze and select ongoing policies where alternative are permitted</li> </ul>	<ul style="list-style-type: none"> <li>• Accounting policy alternatives have been analyzed and recommendations made for the majority of key accounting policy decisions. These accounting policy decisions were approved by senior management and by the audit committee</li> </ul>
Financial statement presentation	<ul style="list-style-type: none"> <li>• Prepare financial statements and note disclosure in compliance with IFRS</li> <li>• Quantify the effects of converting to IFRS</li> <li>• Prepare first-time adoption reconciliations required under IFRS 1</li> </ul>	<ul style="list-style-type: none"> <li>• Financial statement format has been determined for the first interim period in 2011</li> <li>• Note disclosure format and content has been determined for the first interim period in 2011</li> <li>• The effects of the conversion have been quantified</li> <li>• First-time adoption reconciliations are in process and will be completed with the first annual financial statement prepared under IFRS in 2011</li> </ul>
Information technology and data systems	<ul style="list-style-type: none"> <li>• Identify changes required to financial systems and implement solutions</li> <li>• Determine and implement processes for capturing financial information under Canadian GAAP and IFRS in 2010 for comparative information</li> </ul>	<ul style="list-style-type: none"> <li>• Completed – no changes required, financial software upgraded to the most current version</li> <li>• Completed – financial reporting system generates all requisite information and thereby satisfies reporting for 2010 and on a go forward basis for 2011</li> </ul>

Internal control over financial reporting ("ICFR")/Disclosure controls and procedures ("DC&P")	<ul style="list-style-type: none"> <li>• Determine and implement processes for all changes to policies and procedures identified</li> <li>• Design and implement internal controls over the IFRS changeover process</li> </ul>	<ul style="list-style-type: none"> <li>• The assessment is done and changes in accounting policies and financial statement preparation are identified</li> </ul>
Training and communication	<ul style="list-style-type: none"> <li>• Education of management and Audit Committee</li> <li>• External communication regarding IFRS status</li> </ul>	<ul style="list-style-type: none"> <li>• Key individuals involved in the changeover process have been trained</li> <li>• Included in 2009, year-end MD&amp;A and quarterly MD&amp;A's in 2010</li> </ul>

Substantially all of the differences identified between IFRS and Canadian GAAP have now been quantified. While many of the differences will not have a significant impact on the Company's reported results and financial position, some adjustments will be required as a result of IFRS accounting principles and provisions for first-time adoption. These adjustments are outlined in the following sections.

Most adjustments required on transition to IFRS will be made retrospectively against opening deficit as of the date of the first comparative balance sheet presented based on standards applicable at that time. Transitional adjustments relating to those standards where comparative figures are not required to be restated will only be made as of the first day of the year of adoption.

### First-Time Adoption of IFRS

"First-Time Adoption of International Financial Reporting Standards ("IFRS 1")" provides entities adopting IFRS for the first time with a number of optional exemptions and mandatory exceptions, in certain areas, to the general requirement for full retrospective application of IFRS. The most significant IFRS 1 exemptions that are expected to apply to the Company upon adoption are summarized in the following table:

Areas of IFRS	Summary of exemption available
Share-Based Payments	<p><b>Choices:</b> The Company may elect not to apply IFRS 2, "Share-Based Payments", to equity instruments granted on or before November 7, 2002 or which vested before the Company's date of transition to IFRS.</p> <p><b>Policy selection:</b> The Company will elect not to apply the IFRS 2 to equity instruments granted on or before November 7, 2002 or which vested before the company's date of transition to IFRS.</p> <p><b>Expected transition impact:</b> Not quantified.</p> <p><b>Expected future impact:</b> Not quantified.</p>

### Expected areas of significance

The key areas where the Company expects accounting policies may differ and where accounting policy decisions are necessary that may impact the Company's financial statements are set out in the following table. This does not include the transition policy choices made under IFRS 1, as described above.

Accounting Policy Area	Impact of Policy Adoption
Impairment of Assets	<p><b>Choices:</b> There are no policy choices available under IFRS.</p> <p><b>Differences from existing Canadian GAAP:</b> If an indication of impairment exists under Canadian GAAP, the asset's carrying value is compared to the asset's undiscounted cash flows. If the undiscounted cash flows are less than the carrying value, the asset is impaired by an amount equal to the difference between the discounted cash flows and the carrying value. Under IFRS, the asset's carrying value is compared to the asset's discounted cash flows. If the discounted cash flows are less than the carrying value, the asset is impaired by an amount equal to the difference between the discounted cash flows and the carrying value. This may potentially result in more write-downs where carrying values of assets were previously supported under Canadian GAAP on an undiscounted cash flow basis, but could not be supported on a discounted cash flow basis. However, the analytical reporting level under IFRS is higher, which could potentially result in fewer impairments. In addition, IFRS allows the reversal of impairment write-downs, which is prohibited under Canadian GAAP.</p> <p><b>Expected transition impact:</b> The Company completed an impairment review of its assets on January 1, 2010 and concluded that its assets were not impaired in accordance with IFRS.</p> <p><b>Expected future impact:</b> Dependent upon future circumstances.</p>
Property, plant and Equipment	<p><b>Choices:</b> Either historical cost model or a revaluation model can be used to value property, plant and equipment.</p> <p><b>Policy selection:</b> The Company has chosen the historical cost method.</p> <p><b>Differences from existing Canadian GAAP:</b> Under IFRS, where part of an item of property, plant and equipment has a cost that is significant in relation to the cost of the item as a whole, it must be depreciated separately from the remainder of the item. Canadian GAAP is similar in this respect; however it has often not been applied to the same extent due to practicality and/or materiality.</p> <p><b>Expected transition impact:</b> The Company has reviewed its assets to determine if there are any significant components that need to be depreciated separately and has concluded that there are no such assets. There is no impact on reporting.</p> <p><b>Expected future impact:</b> Dependant on future circumstances.</p>
Inventories	<p><b>Choices:</b> Either the first-in first-out (FIFO) or the weighted average method can be used to value inventories.</p> <p><b>Policy selection:</b> The weighted average method will be used to value inventories.</p> <p><b>Differences from existing Canadian GAAP:</b> None</p> <p><b>Expected transition impact:</b> None.</p> <p><b>Expected future impact:</b> None.</p>
Financial instruments	<p><b>Choices:</b> Trade date or settlement date can be used.</p> <p><b>Policy selection:</b> The Company will recognize purchases and sales of financial assets at the trade date.</p> <p><b>Differences from Canadian GAAP:</b> None.</p> <p><b>Expected transition impact:</b> None.</p> <p><b>Expected future impact:</b> None.</p>

Revenue recognition	<p><b>i. Instrumentation</b>  <b>Choices:</b> There are no policy choices under IFRS.  <b>Differences from existing Canadian GAAP:</b> Under IFRS instrumentation provided to customers where all the risks and benefits of ownership are transferred at the time of shipment is recorded as revenue and the cost is expensed in the same period. Under Canadian GAAP, the net cost is recorded as “commercial instruments” and written off over the same period as the related customer contract.  <b>Expected transition impact:</b> Quantified, not significant.  <b>Expected future impact:</b> Not significant.</p> <p><b>i. Access fees and milestone payments</b>  <b>Choices:</b> There are no policy choices under IFRS.  <b>Differences from existing Canadian GAAP:</b> Under IFRS milestone payments received for a license with no further performance obligation to the Company are recognized as income when they are receivable under the terms of the contract and receipt is probable. Under Canadian GAAP access fees and milestone payments are recorded as deferred revenue and taken into income over the term of the license or the remaining life of the related patent, whichever is shorter.  <b>Expected transition impact:</b> Quantified, not significant.  <b>Expected future impact:</b> Not significant.</p>
Statement of Cash Flows	<p><b>Choices:</b> Either the direct or indirect method may be presented. Interest paid or received can be presented as either operating or financing activities.  <b>Policy selection:</b> The Company will use the indirect method.  <b>Differences from Canadian GAAP:</b> None.  <b>Expected transition impact:</b> None.  <b>Expected future impact:</b> None.</p>
Statement of loss and comprehensive loss	<p><b>Choices:</b> Either the “by function” or “by nature” method may be presented.  <b>Policy selection:</b> The Company will use the “by nature” method.  Expenditures related to the EUPHRATES clinical trial will be disclosed in a note to the financial statements according to function.  <b>Differences from Canadian GAAP:</b> None.  <b>Expected transition impact:</b> None.  <b>Expected future impact:</b> None.</p>

The above list and related comments should not be regarded as a complete list of changes that will result from the transition to IFRS. It is intended to highlight those areas that are considered to be the most significant. Until the Company has prepared a full set of annual financial statement under IFRS, it will not be able to determine or precisely quantify all of the impacts that will result from converting to IFRS. Furthermore, the standards are in a constant state of transition and refinement. The ultimate differences between GAAP and IFRS cannot be completely determined at this time. All potential changes are monitored and evaluated and will be adopted as required.

## **RISK MANAGEMENT**

### **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.

#### **(i) Credit Risk**

Cash: The Company places its cash with Canadian Schedule I banks.

Cash equivalent: Cash equivalent consist of a premium money market investment account placed with a Canadian Schedule I bank. The premium money market investment account can be converted to cash on demand.

Short-term investment: Short-term investment includes an interest bearing security with an original maturity of greater than three months and remaining maturity of less than one year. The short-term investment is classified as held-for-trading and is accounted for at fair value.

Accounts receivable: The Company sells its products to distribution partners in major markets. The credit risk associated with the accounts receivable pursuant to these agreements is evaluated during initial negotiations and on an ongoing basis. There have been no events of default under these agreements. As at December 31, 2010 and 2009, no material accounts receivable balances were considered impaired or past due.

#### **(ii) Liquidity Risk**

The Company has no long-term debt that requires repayment in cash. The convertible notes payable (face value \$2,500) were settled and converted to equity during the year. Accounts payable and accrued liabilities are settled in the regular course of business based on negotiated terms with trade suppliers and will be paid in less than one year. The carrying values of the above balances approximate their fair values.

#### **(iii) Market Risk**

Currency risk: The majority of the Company's revenue is denominated in US dollars and Euros. At December 31, 2010, cash included US\$317. Accounts receivable included a total of \$415 US and 43 Euros. Accounts payable and accrued liabilities included a total of \$301 US and nil Euros. There is no active hedging program currently in place due to the relatively short time frame for settlement of these balances. A 10% change in the US/CDN or EURO/CDN exchange rate on the December 31, 2010 amounts would have a \$49 impact on net income.

Interest rate risk: The Company has minimal exposure to fluctuations in interest rates. The convertible notes payable are non interest bearing.

### **CAPITAL RISK MANAGEMENT**

The Company's primary objective, when managing capital, is to maintain appropriate levels of cash and cash equivalents for working capital and operating purposes, as well as funding commercialization of its core products. Capital includes shareholders' equity, and the convertible notes payable.

## **FINANCIAL INSTRUMENTS**

All financial instruments are measured at fair value on initial recognition. After initial recognition, financial instruments are measured at their fair values, except for financial assets classified as held-to-maturity or loans and receivable and other financial liabilities, which are measured at amortized cost.

Amortized cost related to financial assets classified as held-to-maturity of loans and receivable and other financial liabilities is calculated using the effective interest method with changes recognized as income or expense in earnings (loss).

Gains and losses related to financial assets and financial liabilities classified as held-for trading are recorded in earnings (loss) in the period in which they arise. The Company designates financial assets and financial liabilities as held-for-trading if they are acquired or incurred principally for the purpose of selling or repurchasing in the near term.

If a financial asset is classified as available-for-sale, the cumulative unrealized gain or loss is recognized in accumulated other comprehensive income (loss) and recognized in earnings upon sale or other-than-temporary impairment. The Company assesses whether a financial asset is other-than-temporarily impaired by assessing whether there is a significant or prolonged decline in fair value and objective evidence of impairment exists such a financial difficulty, breach or default of contracts, probability of bankruptcy or other financial reorganization.

The Company applies trade date accounting for its purchase and sales of financial assets.

## **TRANSACTION COSTS**

Transaction costs directly attributable to financial assets and liabilities that are not classified as held-for-trading are included in the amortized cost of the related asset or liability and recognized in earnings through the effective interest method. Transaction costs related to held-for-trading financial assets and liabilities are expensed as incurred.

The Company does not enter into financial instruments for trading or speculative purposes.

Accounts payable and accrued liabilities are classified as other financial liabilities and are carried at amortized cost using the effective interest rate method.

Notes payable are classified as other financial liabilities and are carried at amortized cost using the effective interest rate method.

## **REVENUE RECOGNITION**

Product sales are recognized as revenue when evidence of a contract exists, the selling price is *fixed* and determinable, collection is reasonably assured and on shipment to respective customers. Royalty revenue from technology licence agreements is recognized over the term of the agreements based on sales of the underlying products. Technology access fees and milestone payments are recognized as revenue over the term of related licence agreements. The difference between payments received and amounts recognized as revenue is reflected in the balance sheet as deferred revenue.

## **INVENTORIES**

The Company maintains a reserve for estimated excess and obsolete inventories based on management's review of inventories on hand compared to estimated future usage, sales projections and the likelihood of obsolescence.

## **COMMERCIAL INSTRUMENTS**

The cost of EAA™ instrumentation is amortized over an estimated useful life of three years. This period also coincides with the initial term of commercial contracts over which minimum performance levels must be achieved by the customers. Unamortized costs are reflected on the balance sheet as commercial instruments. Commercial instruments were fully amortized in 2010.

## **INCOME TAXES**

As at December 31, 2010, the Company has approximately \$17,943 in future income tax assets consisting primarily of operating loss carry forwards and discretionary research development expenditures. A valuation allowance has been recorded to offset these future income tax assets, as the Company has determined it is less likely than not that these assets will be realized. The Company will continue to assess the likelihood of realization of such assets as future events occur.

## **PURCHASED TECHNOLOGY AND LICENSES**

Purchased technology is recorded at cost and amortized on a straight-line basis over its estimated useful life of 10 years. The carrying value is reviewed regularly for recoverability based on the expected future net cash inflows generated by the related assets. Any permanent impairment in the carrying value of purchased technology is charged to income at the time of its determination. Purchased technology will be completely amortized in 2011.

On April 21, 2010, the Company paid \$502 to a third party pursuant of the terms of a license agreement granting Spectral the exclusive development and commercial right in the US for Toraymyxin. This amount will be amortized over the remaining term of the license, unless there is a permanent impairment in value, in which case it will be written off.

## **RESEARCH AND PRODUCT DEVELOPMENT COSTS**

Research costs are expensed as incurred. Development costs are expensed until such time as they meet Canadian generally accepted accounting criteria for deferral.

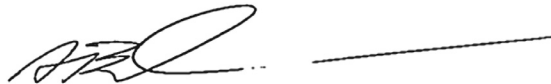
Investment tax credits and government assistance related to certain qualified research and development activities and equipment purchases are reflected as either expense recoveries or as a reduction of the carrying value of capital assets when received.

**MANAGEMENT’S RESPONSIBILITY FOR FINANCIAL STATEMENTS**

The financial statements have been prepared by management, who are responsible for the integrity and objectivity of this information. The statements have been prepared in conformity with generally accepted accounting principles in Canada and, where appropriate, include amounts based on management estimates. Financial information elsewhere in the Annual Report is consistent with that in the financial statements. The Company maintains a system of internal controls designed to provide reasonable assurance that transactions are recorded and executed in accordance with the Company’s authorized practice, that assets are properly safeguarded and that reliable financial records are maintained. PricewaterhouseCoopers LLP, Chartered Accountants, the external auditors appointed by the shareholders, are engaged to provide an independent audit of the financial information. The Finance and Audit Committee of the Board of Directors, all of whom are outside Directors, meet periodically with management and the external auditors to discuss audit and financial matters. In addition, this committee reviews the quarterly and annual financial statements of the Company and submits its report to the Board of Directors. The financial statements are approved by the Board of Directors.



*Paul M. Walker*  
*President & Chief Executive Officer*



*Anthony Busiskas*  
*Executive V.P. & Chief Financial Officer*

March 10, 2011

## **Independent Auditor's Report**

### **To the Shareholders of Spectral Diagnostics Inc.**

We have audited the accompanying financial statements of Spectral Diagnostics Inc., which comprise the balance sheets as at December 31, 2010 and 2009 and the statements of operations, comprehensive loss and deficit and cash flows for the years then ended, and the related notes including a summary of accounting policies.

#### **Management's responsibility for the financial statements**

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Canadian generally accepted accounting principles and for such internal control as management determines is necessary to enable the preparation 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 financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the 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 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. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

#### **Opinion**

In our opinion, these financial statements present fairly, in all material respects, the financial position of Spectral Diagnostics Inc. as at December 31, 2010 and 2009 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

*PricewaterhouseCoopers LLP*

**Chartered Accountants, Licensed Public Accountants**

Toronto, Ontario

# **Spectral Diagnostics Inc.**

Financial Statements

**December 31, 2010 and 2009**

# Spectral Diagnostics Inc.

## Balance Sheets

As at December 31, 2010 and 2009

(in thousands of dollars)

	2010 \$	2009 \$
<b>Assets</b>		
<b>Current assets</b>		
Cash and cash equivalent	10,311	2,944
Short-term investment (note 5)	5,021	-
Accounts receivable	595	781
Inventories (note 6)	209	123
Prepaid expenses	31	45
	<u>16,167</u>	<u>3,893</u>
<b>Property, plant and equipment</b> (note 7)	526	457
<b>Commercial instruments</b> (note 8)	-	94
<b>Purchased technology and licences</b> (note 9)	602	588
	<u>17,295</u>	<u>5,032</u>
<b>Liabilities</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities	1,322	1,077
Current portion of convertible notes payable (notes 4 and 10)	-	2,336
	<u>1,322</u>	<u>3,413</u>
<b>Deferred revenue</b>	226	254
<b>Convertible notes payable</b> (notes 4 and 10)	-	-
	<u>1,548</u>	<u>3,667</u>
<b>Shareholders' Equity</b>		
<b>Common shares</b> (notes 4, 10 and 11(a))	17,538	2,524
<b>Other equity</b> (note 11(b))	11,729	5,794
<b>Deficit</b>	<u>(13,520)</u>	<u>(6,953)</u>
	<u>15,747</u>	<u>1,365</u>
	<u>17,295</u>	<u>5,032</u>
<b>Commitments and contingencies</b> (note 14)		

Approved by the Board of Directors

(signed) R. Ian Lennox \_\_\_\_\_ Director

(signed) Edward McCormack \_\_\_\_\_ Director

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

# Spectral Diagnostics Inc.

## Statements of Operations, Comprehensive Loss and Deficit For the years ended December 31, 2010 and 2009

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

	<b>2010</b>	<b>2009</b>
	<b>\$</b>	<b>\$</b>
<b>Sales</b>	2,821	3,283
<b>Cost of sales</b>	674	836
<b>Gross margin</b>	2,147	2,447
<b>Operating expenses</b>		
Selling, general and administrative	4,060	3,607
Clinical trial	2,053	503
Service fees (note 17)	1,000	-
Amortization	644	635
Foreign currency exchange loss	64	128
Stock-based compensation (notes 11(b) and (d))	792	78
Research and product development, net of credits (note 12)	24	68
	8,637	5,019
<b>Loss before the following</b>	(6,490)	(2,572)
<b>Interest on convertible notes payable</b>	(164)	(164)
<b>Other net investment income (loss)</b>	87	(28)
<b>Loss and comprehensive loss for the year</b>	(6,567)	(2,764)
<b>Deficit - Beginning of year</b>	(6,953)	(4,189)
<b>Deficit - End of year</b>	(13,520)	(6,953)
<b>Basic and diluted loss per common share</b>	(0.10)	(0.11)
<b>Weighted average number of common shares outstanding</b>	67,210,554	24,118,424

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

**Spectral Diagnostics Inc.**  
**Statements of Cash Flows**  
**For the years ended December 31, 2010 and 2009**

(in thousands of dollars)

	<b>2010</b>	<b>2009</b>
	<b>\$</b>	<b>\$</b>
<b>Cash provided by (used in)</b>		
<b>Operating activities</b>		
Loss for the year	(6,567)	(2,764)
Items not affecting cash		
Amortization	644	635
Amortization of commercial instruments included in cost of sales	131	86
Stock-based compensation expense	792	78
Interest on convertible notes payable	164	164
Changes in non-cash working capital (note 15)	359	693
	<u>(4,477)</u>	<u>(1,108)</u>
<b>Financing activities</b>		
Proceeds on issue of private placement (note 4)	17,608	-
Proceeds on exercise of stock options (note 11(a))	49	-
	<u>17,657</u>	<u>-</u>
<b>Investing activities</b>		
Purchase of property, plant and equipment	(225)	(129)
Purchase of commercial instruments	(37)	(48)
Purchase of technology and licences	(502)	-
(Increase) decrease in short-term investment (note 5)	(5,021)	4,000
Decrease in deferred revenue	(28)	(68)
	<u>(5,813)</u>	<u>3,755</u>
<b>Increase in cash and cash equivalent during the year</b>	<b>7,367</b>	<b>2,647</b>
<b>Cash and cash equivalent - Beginning of year</b>	<b>2,944</b>	<b>297</b>
<b>Cash and cash equivalent - End of year</b>	<b>10,311</b>	<b>2,944</b>
<b>Cash and cash equivalent are represented by</b>		
Bank accounts	400	442
Cash equivalent	9,911	2,502
	<u>10,311</u>	<u>2,944</u>
<b>Non-cash working capital and financing activities</b>		
Decrease in current portion of convertible notes payable	(2,500)	-
Settlement of convertible notes payable	2,500	-

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

# Spectral Diagnostics Inc.

Notes to Financial Statements

December 31, 2010 and 2009

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

## 1 Nature of operations

Spectral Diagnostics Inc. (Spectral or the Company) was incorporated on July 29, 1991 in Ontario, Canada. The Company is strategically focused on the development and commercialization of a treatment for severe sepsis utilizing its Endotoxin Activity Assay (EAA™) diagnostic and the Toraymyxin therapeutic. A US pivotal clinical trial for Toraymyxin (the EUPHRATES trial) is scheduled to be implemented in 15 sites by the end of the first half in 2011. All costs related to this regulatory approval process are being charged to earnings (loss) as clinical trial costs.

Current revenues are derived primarily from the sale of the Company's EAA™ diagnostic and of certain proprietary biochemicals and related royalties highlighted by its single chain Troponin I products.

## 2 Summary of significant accounting policies

These financial statements have been prepared in accordance with Canadian generally accepted accounting principles (GAAP). Significant accounting policies are outlined below.

### Cash and cash equivalent

The Company places its cash balances with Canadian Schedule I banks.

The cash equivalent consists of a premium money market investment account and is placed with Canadian Schedule I banks, and the premium money market investment account can be converted to cash on demand. The money market account provides a nominal rate of return, which is commensurate with a low investment risk. All cash and the cash equivalent are classified as held-for-trading and are accounted for at fair value.

### Short-term investment

The short-term investment includes an interest bearing security with an original maturity of greater than three months and remaining maturity of less than one year. The short-term investment is classified as held-for-trading and is accounted for at fair value. Related interest income is included in "Other net investment income (loss)" on the statements of operations, comprehensive loss and deficit.

The Company assesses declines in the value of individual investments for impairment to determine whether the decline is other-than temporary. The Company makes this assessment by considering available objective evidence, including changes in specific industry and individual company data, the length of time and the extent to which the fair value has been less than cost, the financial condition and the near-term prospects of the individual investment. In the event that an impairment exists and the impairment is considered to be other than temporary, an impairment charge is recorded in the statements of operations, comprehensive loss and deficit and a new cost basis in the investment is established.

# Spectral Diagnostics Inc.

Notes to Financial Statements

December 31, 2010 and 2009

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

## Inventories

Inventories comprise raw materials and supplies, work-in-progress and finished goods, which are valued at the lower of cost and net realizable value, determined on an average cost basis. The cost of raw materials and acquired finished goods inventories includes direct costs. The cost of manufactured inventory includes the cost of raw materials, direct labour and attributable overhead.

## Revenue recognition

Product sales are recognized as revenue when evidence of a contract exists, the selling price is fixed and determinable, collection is reasonably assured and on shipment to respective customers. Royalty revenue from technology licence agreements is recognized over the terms of the related agreements, based on sales of the underlying products and when collection is reasonably assured. Technology access fees and milestone payments are recognized as revenue over the terms of the related licence agreements. The difference between payments received and amounts recognized as revenue is reflected in the balance sheets as deferred revenue.

## Property, plant and equipment

Property, plant and equipment are recorded at cost, less applicable government grants and investment tax credits. Amortization commences when the assets are available for use and is recorded on a straight-line basis over the estimated useful lives of the assets as follows:

Laboratory equipment	5 years
Office equipment and furniture	5 years
Computer equipment	3 years
Leasehold improvements	over the term of the lease

Instrumentation associated with the EUPHRATES trial and provided to clinical sites is recorded at cost. Amortization is recorded on a straight-line basis and commences when the instrument is supplied to the clinical site, over the estimated useful life, which is consistent with laboratory equipment.

Property, plant and equipment are reviewed for impairment whenever events or changes in circumstances support that the carrying value of an asset may not be recoverable.

An impairment loss is recognized when the carrying value of an asset exceeds the projected undiscounted future net cash flows expected from its use and disposal. The impairment loss is measured as the amount by which the carrying value of the asset exceeds its fair value, which is determined by discounted cash flows when quoted market prices are not available.

## Commercial instruments

The cost of EAA<sup>TM</sup> instrumentation placed with customers is amortized over an estimated useful life of three years. This period also coincides with the initial term of commercial contracts over which minimum performance levels must be achieved by the customers. Unamortized costs are reflected in the balance sheets as commercial instruments.

# **Spectral Diagnostics Inc.**

Notes to Financial Statements

**December 31, 2010 and 2009**

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

## **Foreign currency translation**

Transactions denominated in foreign currencies are translated using the temporal method. Under the temporal method, monetary assets and liabilities are translated into Canadian dollars at the foreign currency exchange rates in effect at the balance sheet dates. Non-monetary assets and liabilities are translated at the rates of exchange in effect at the transaction dates. Revenues and expenses are translated at the foreign currency exchange rates prevalent at the transaction dates, except for amortization, which is translated at the foreign currency exchange rate in effect when the related assets were acquired. Foreign currency exchange gains and losses are reflected in the statements of operations, comprehensive loss and deficit in the year in which they occur.

## **Research and product development costs**

Research costs are expensed as incurred. Development costs are expensed until they meet Canadian generally accepted accounting criteria for capitalization.

Investment tax credits and government assistance related to certain qualified research and development activities and equipment purchases are reflected as either expense recoveries or as a reduction of the carrying value of property, plant and equipment when collection is reasonably assured.

## **Purchased technology and licences**

Purchased technology and licences are recorded at cost and amortized on a straight-line basis over their estimated useful lives. Purchased technology has an estimated useful life of ten years and purchased licences have estimated useful lives of 20 years. The carrying values are reviewed for recoverability, based on the expected future net cash inflows generated by the related assets, whenever events or changes in circumstances indicate that the carrying values may not be recoverable. Any permanent impairment in the carrying value of purchased technology and/or licences are charged to earnings (loss) at the time of its determination. Purchased technology will be completely amortized in the first quarter of 2011.

## **Stock-based compensation**

The fair value of all stock-based compensation awards is estimated using the Black-Scholes option pricing model at the date of grant and is expensed to operations over each award's vesting period.

Any consideration paid by employees on the exercise of stock options or the purchase of stock is credited to capital stock. If common shares or stock options are repurchased from employees, the excess of the consideration paid over the carrying value of the common shares or stock options cancelled is charged to deficit.

## **Income taxes**

The Company uses the asset and liability method of accounting for income taxes. Under this method, future income tax assets and liabilities are determined based on the differences between the financial reporting and income tax bases of assets and liabilities that are measured using substantively enacted income tax rates and

# Spectral Diagnostics Inc.

Notes to Financial Statements

December 31, 2010 and 2009

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

laws. The Company provides a valuation allowance for future income tax assets when it is more likely than not that some portion or all of the future income tax assets will not be realized.

## **Earnings (loss) per common share**

Basic earnings (loss) per common share are calculated by dividing the earnings (loss) for the year by the weighted average number of common shares outstanding during the year. Diluted earnings (loss) per common share are computed in accordance with the treasury stock method and are based on the weighted average number of common shares and dilutive common share equivalents outstanding.

## **Use of estimates**

The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. The most significant estimates are related to the recoverability of purchased technology and licences, property, plant and equipment and valuation assumptions related to stock-based compensation. Actual results could differ from those estimates.

## **Financial instruments**

All financial instruments are measured at their fair values on initial recognition. After initial recognition, financial instruments are measured at their fair values, except for financial assets classified as held-to-maturity or loans and receivables and other financial liabilities, which are measured at amortized cost.

Amortized cost related to financial assets classified as held-to-maturity or loans and receivables and other financial liabilities is calculated using the effective interest method with changes recognized as income or expense in earnings (loss).

Gains and losses related to financial assets and financial liabilities classified as held-for trading are recorded in earnings (loss) in the year in which they arise. The Company designates financial assets and financial liabilities as held-for-trading if they are acquired or incurred principally for the purpose of selling or repurchasing in the near term.

If a financial asset is classified as available-for-sale, the cumulative unrealized gain or loss is recognized in accumulated other comprehensive income (loss) and recognized in earnings (loss) on sale or other than temporary impairment. The Company assesses whether a financial asset is other than temporarily impaired by assessing whether there is a significant or prolonged decline in fair value and objective evidence of impairment exists, such as financial difficulty, breach or default of contracts, probability of bankruptcy or other financial reorganization.

The Company applies trade date accounting for its purchases and sales of financial assets.

# Spectral Diagnostics Inc.

Notes to Financial Statements

December 31, 2010 and 2009

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

## Transaction costs

Transaction costs directly attributable to financial assets and financial liabilities that are not classified as held-for-trading are included in the amortized cost of the related financial asset or financial liability and recognized in earnings (loss) through the effective interest rate method. Transaction costs related to held-for-trading financial assets and financial liabilities are expensed as incurred.

The Company does not enter into financial instruments for trading or speculative purposes.

Accounts payable and accrued liabilities are classified as other financial liabilities and are carried at amortized cost using the effective interest rate method.

Convertible notes payable are classified as other financial liabilities and are carried at amortized cost using the effective interest rate method.

## Risk management

### a) 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.

#### i) Credit risk

Cash

The Company places its cash with Canadian Schedule I banks.

Cash equivalent

The cash equivalent consists of a premium money market investment account placed with a Canadian Schedule I bank. The premium money market investment account can be converted to cash on demand.

Short-term investment

Short-term investment includes an interest bearing security with an original maturity of greater than three months and remaining maturity of less than one year. The short-term investment is classified as held-for-trading and is accounted for at fair value.

# Spectral Diagnostics Inc.

Notes to Financial Statements

December 31, 2010 and 2009

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

## Accounts receivable

The Company sells its products to distribution partners in major markets. The credit risk associated with the accounts receivable pursuant to these agreements is evaluated during initial negotiations and on an ongoing basis. There have been no events of default under these agreements. As at December 31, 2010 and 2009, no material accounts receivable balances were considered impaired or past due.

## ii) Liquidity risk

The Company has no long-term debt that requires repayment in cash. The convertible notes payable (face value of \$2,500) were settled and converted to equity during 2010. Accounts payable and accrued liabilities are settled in the regular course of business, based on negotiated terms with trade suppliers and will be paid in less than one year. The carrying values of the above balances approximate their fair values.

## iii) Market risk

### Currency risk

The majority of the Company's revenue is denominated in US dollars and euros. As at December 31, 2010, cash and cash equivalents included US\$317. Accounts receivable included a total of US\$415 and €43. Accounts payable and accrued liabilities included a total of US\$301 dollars and €nil. There is no active hedging program currently in place due to the relatively short time frame for settlement of these balances. A 10% change in the US dollar / Canadian dollar or euro / Canadian dollar exchange rates on the December 31, 2010 amounts would impact earnings by \$49.

### Interest rate risk

The Company has minimal exposure to fluctuations in interest rates. The convertible notes payable are non-interest bearing.

## b) Capital management

The Company's primary objective when managing capital is to maintain appropriate levels of cash and cash equivalent for working capital and operating purposes, as well as funding commercialization of its core products. Capital includes shareholders' equity and the convertible notes payable.

## 3 Adoption of new accounting policies

In January 2006, The Canadian Institute of Chartered Accountants Accounting Standards Board (AcSB) adopted a strategic plan for the direction of accounting standards in Canada. As part of that plan, the AcSB confirmed in February 2008 that International Financial Reporting Standards (IFRS) will replace Canadian GAAP over a transition period, which will end in 2011, when IFRS will be fully adopted for profit-oriented,

# Spectral Diagnostics Inc.

## Notes to Financial Statements

December 31, 2010 and 2009

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

publicly accountable enterprises. The Company will be required to report its results in accordance with IFRS, commencing on January 1, 2011, with appropriate comparative IFRS financial information for 2010.

The Company has developed its plan and has determined that its internal control, accounting and reporting systems will satisfy the financial and disclosure requirements imposed by the adoption of this new standard.

The Company has determined that the transition to IFRS will not have a material impact on its financial results, internal control over financial reporting, disclosure controls and procedures and business activities. As part of its IFRS implementation plan, the Company continues to review the impact on its disclosure controls and procedures and internal control over financial reporting.

### 4 Financing

On March 2, 2010, the Company completed a private placement financing, whereby the Company issued 48,750,000 Units of the Company (the Units), at a price of \$0.40 per Unit, to a group of investors for aggregate gross proceeds of \$19,500. The Company received net proceeds of \$17,608. Each Unit consists of one common share of the Company (common share) and one half of one common share purchase warrant (each whole common share purchase warrant) entitling the holder thereof to acquire one common share at a price of \$0.60 per common share for a period of four years from closing.

In connection with the financing, and as partial consideration for services performed, the Company also issued broker warrants to Desjardins Securities Inc., which acted as agent for the financing, which will entitle it to acquire 1,462,500 common shares at an exercise price of \$0.40 per common share, and a further 731,250 common shares at an exercise price of \$0.60 per common share, in each case, for a period of four years from closing.

The Company has also issued 2,890,625 common shares to GrowthWorks Canadian Fund Ltd., at a deemed price of \$0.40 per common share as full repayment and final settlement of a non-interest bearing, unsecured, convertible promissory note in the principal amount of \$1,156, dated June 19, 2006.

### 5 Short-term investment

The short-term investment consists of the following:

	2010	2009
	\$	\$
Guaranteed investment certificate, non-redeemable, bearing interest at 1.3%, due on May 30, 2011	5,021	-

# Spectral Diagnostics Inc.

Notes to Financial Statements

December 31, 2010 and 2009

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

## 6 Inventories

	2010	2009
	\$	\$
Raw materials and supplies	57	21
Work-in-progress	13	5
Finished goods	139	97
	<u>209</u>	<u>123</u>

## 7 Property, plant and equipment

	<u>2010</u>		
	Cost	Accumulated amortization	Net
	\$	\$	\$
Laboratory equipment	1,005	523	482
Office equipment and furniture	332	314	18
Computer equipment	159	142	17
Leasehold improvements	66	57	9
	<u>1,562</u>	<u>1,036</u>	<u>526</u>
	<u>2009</u>		
	Cost	Accumulated amortization	Net
	\$	\$	\$
Laboratory equipment	811	384	427
Office equipment and furniture	318	307	11
Computer equipment	142	136	6
Leasehold improvements	66	53	13
	<u>1,337</u>	<u>880</u>	<u>457</u>

## 8 Commercial instruments

	2010	2009
	\$	\$
Commercial instruments, at cost	338	300
Less: Accumulated amortization	<u>338</u>	<u>206</u>
	<u>-</u>	<u>94</u>

# Spectral Diagnostics Inc.

Notes to Financial Statements

December 31, 2010 and 2009

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

The commercial instruments were fully amortized during the year.

## 9 Purchased technology and licences

	2010 \$	2009 \$
Purchased technology, at cost	5,208	4,706
Less: Accumulated amortization	4,606	4,118
	<u>602</u>	<u>588</u>

Purchased technology comprises technology relating to the EAA<sup>TM</sup> product line.

On April 21, 2010, the Company paid \$502 to a third party pursuant to the terms of a licence agreement granting Spectral the exclusive development and commercial rights in the United States for Toraymyxin. This amount will be amortized over the remaining term of the licence, unless there is a permanent impairment in value, in which case it will be written off.

In addition, on obtaining market approval from the U.S. Food and Drug Administration for Toraymyxin, the Company would be required to pay an additional \$1,000 in cash and issue 500,000 common shares to the third party.

## 10 Convertible notes payable

	2010 \$	2009 \$
Promissory convertible notes payable, face value of \$2,500, unsecured, non-interest bearing, due on December 31, 2010, payable in cash or common shares at the option of the Company (such common shares would be issued at the then market price, less a 15% discount). The promissory convertible notes payable were originally recorded at their estimated fair value using an effective interest rate of 7%. The difference between the recorded fair value and face value is being amortized over the term of these notes and is charged as interest expense	<u>-</u>	<u>2,336</u>

On March 2, 2010, the Company issued 2,890,625 common shares to GrowthWorks Canadian Fund Ltd., at a deemed price of \$0.40 per common share as full repayment and final settlement of a non-interest bearing, unsecured, convertible promissory note in the principal amount of \$1,156, dated June 19, 2006.

On December 31, 2010, the Company issued a total of 4,648,512 common shares to three noteholders at a conversion price of approximately \$0.29 per common share, as full repayment and final settlement of the remaining notes in the principal amount of \$1,344. The conversion was in accordance with the terms of the notes. Following the conversion, the notes were cancelled.

# Spectral Diagnostics Inc.

Notes to Financial Statements

December 31, 2010 and 2009

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

## 11 Capital stock

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

a) Details of the common shares issued and outstanding are as follows:

	2010		2009	
	Number of common shares	Amount \$	Number of common shares	Amount \$
Balance - Beginning of year	24,118,424	2,524	24,118,424	2,524
Private placement (note 4)	48,750,000	12,465	-	-
Settlement of convertible notes payable (note 4)	2,890,625	1,156	-	-
Settlement of convertible notes payable (note 10)	4,648,512	1,344	-	-
Exercise of stock options	142,500	49	-	-
Balance - End of year	80,550,061	17,538	24,118,424	2,524

b) Details of other equity are as follows:

	Contributed surplus \$	Stock-based compensation \$	Warrants \$	Total \$
Balance - December 31, 2008	3,696	1,852	168	5,716
Stock-based compensation expense	-	78	-	78
Balance - December 31, 2009	3,696	1,930	168	5,794
Private placement (note 4)	-	-	5,143	5,143
Stock-based compensation expense	-	792	-	792
Balance - December 31, 2010	3,696	2,722	5,311	11,729

# Spectral Diagnostics Inc.

Notes to Financial Statements

December 31, 2010 and 2009

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

c) Details of the share purchase warrants are as follows:

Issuance date	Expiry date	Number outstanding	Exercise price per common share \$
June 19, 2006	June 19, 2011	500,000	0.47
March 2, 2010	March 2, 2014	25,106,250	0.60
March 2, 2010	March 2, 2014	1,462,500	0.40

Warrants issued during 2010 are exercisable at prices ranging from \$0.40 to \$0.60 per share. Warrants granted were valued using the Black-Scholes option pricing model, with the following assumptions: risk-free interest rate of 2.3%; expected life of four years; expected volatility of 105%; and expected annual dividends of \$nil. The total fair value of the warrants granted in 2010 was determined to be \$5,143.

d) Stock options

The Company has reserved an aggregate of 8,055,006 common shares for issuance under certain stock option plans for its employees, officers and directors. A total of 3,867,500 common share options are currently outstanding as granted and the remaining 4,187,506 are available for grant. Stock options are granted at market prices. Vesting and expiry dates of the stock options vary and are authorized by the Board of Directors at the time of the grant.

Details of stock options granted, exercised and expired/forfeited are as follows:

	Number of common shares		Weighted average exercise price per share \$
	Total	Officers/directors	
Outstanding - December 31, 2008	2,045,000	1,700,000	0.55
Granted	365,000	310,000	0.28
Outstanding - December 31, 2009	2,410,000	2,010,000	0.51
Granted	1,950,000	1,875,000	0.42
Exercised	(142,500)	(75,000)	0.32
Expired/forfeited	(350,000)	(350,000)	1.04
Outstanding - December 31, 2010	3,867,500	3,460,000	0.42

Stock options granted and outstanding as at December 31, 2010 expire at various dates from 2011 to 2015, with a weighted average contractual life of 2.8 years. Stock options are exercisable at prices ranging from \$0.30 to \$0.61 per share as follows:

# Spectral Diagnostics Inc.

Notes to Financial Statements

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

Price range \$	Outstanding			Exercisable	
	Number of stock options outstanding	Weighted average remaining contractual life in years	Weighted average exercise price per share \$	Number of stock options exercisable	Weighted average exercise price per share \$
0.30 to 0.40	2,027,500	4.10	0.39	2,027,500	0.39
0.43 to 0.51	1,690,000	1.00	0.45	1,690,000	0.45
0.61	150,000	4.20	0.61	150,000	4.20
	<u>3,867,500</u>	2.75	0.42	<u>3,867,500</u>	0.42

Stock options granted were valued using the Black-Scholes option pricing model, with the following assumptions: risk-free interest rate of 2.5%; expected life of five years; expected volatility of 105%; and expected annual dividends of \$nil. The total fair value of the stock options granted in 2010 was determined to be \$792. In 2010, \$792 relating to all stock options vested was included in contributed surplus and in the statements of operations, comprehensive loss and deficit.

## 1998 Employee Stock Purchase plan

The Company's 1998 Employee Stock Purchase Plan (the Stock Purchase Plan) was adopted by the Board of Directors in August 1998 and was approved by the shareholders in September 1998. 300,000 common shares have been reserved for issuance under the Stock Purchase Plan. The Stock Purchase Plan has, at the discretion of the Board of Directors, two six-month offering periods each year. Employees of the Company (excluding officers and directors) are eligible to participate. The Stock Purchase Plan permits eligible employees to purchase common shares at a price equal to 90% of the fair value of the Company's common shares, based on the weighted average of the trading prices of the common shares of the Company during the five trading days prior to approval of the issuance of common shares by the Board of Directors. Employees may end their participation in the offering at any time during the offering period and participation ends automatically on termination of employment with the Company. During the years ended December 31, 2010 and 2009, no common shares were issued under the Stock Purchase Plan.

# Spectral Diagnostics Inc.

Notes to Financial Statements

December 31, 2010 and 2009

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

## 12 Research and product development

	2010 \$	2009 \$
Research and product development costs	44	147
Less: National Research Council Canada - IRAP	20	79
	<hr/> 24	<hr/> 68

On February 2, 2008, the Company entered into an agreement with National Research Council Canada under the Industrial Research Assistance Program (IRAP), whereby funding would be provided for a two-year period up to a maximum of \$163 toward certain costs for a specific project undertaken by the Company. The agreement expired in 2010, and the project was completed. There will be no further funding from this program.

## 13 Income taxes

The income tax effects of temporary differences and operating losses that give rise to future income tax assets are as follows:

	2010 \$	2009 \$
Future income tax assets		
Operating loss carry-forwards	5,832	4,585
Capital loss carry-forwards	2,401	2,396
Research and development expenditures	6,159	6,299
Net non-refundable investment tax credits	2,347	2,347
Income tax basis of property, plant and equipment in excess of carrying value and other temporary differences	<hr/> 1,204	<hr/> 1,058
	17,943	16,685
Less: Valuation allowance	<hr/> 17,943	<hr/> 16,685
	<hr/> -	<hr/> -

# Spectral Diagnostics Inc.

## Notes to Financial Statements

December 31, 2010 and 2009

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

As at December 31, 2010, the Company's income tax benefits, for which a valuation allowance has been established, expire as follows:

a) Operating loss carry-forwards expire in varying amounts as follows:

	\$
2014	1,194
2025	12,342
2026	1,061
2027	1,052
2028	796
2029	1,844
2030	5,039
	<hr/>
	23,328
	<hr/>

b) Research and development expenditures of approximately \$24,634, which may be used to reduce future years' taxable income, can be carried forward indefinitely.

c) Non-refundable investment tax credits of approximately \$2,761, which may be applied against future income taxes payable, expire in varying amounts from 2017 to 2026.

## 14 Commitments and contingencies

As at December 31, 2010, the Company's future lease commitments for rental of the premises are \$127 and \$131 in 2011 and 2012, respectively.

Rent expense for the year ended December 31, 2010 amounted to \$122 (2009 - \$117).

### Patents

The Company has, in the course of its operations, a patenting program to protect its proprietary technology. The extent to which biotechnical discoveries and related products and processes can be effectively protected by patent is uncertain and is subject to interpretation by the courts. The Company's technology, products and processes may be subject to claims of infringement on the patents of others and, if such challenges were successful, this could result in the requirement to access such technologies through licence agreements.

# Spectral Diagnostics Inc.

Notes to Financial Statements

December 31, 2010 and 2009

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

## 15 Supplemental cash flow information

	2010 \$	2009 \$
Changes in non-cash working capital		
Accounts receivable	186	79
Inventories	(86)	80
Prepaid expenses	14	(3)
Accounts payable and accrued liabilities	245	537
	<hr/> 359	<hr/> 693

## 16 Segmented information

The operating segments of the Company have been aggregated into one reportable segment, based on their similar economic characteristics, products and class of customer.

### a) Sales by geographic location

	2010 \$	2009 \$
Canada	1	2
United States	1,875	2,326
Europe and other	945	955
	<hr/> 2,821	<hr/> 3,283

### b) Sales to major customers

The Company derives a significant portion of its revenues from three customers, representing 51% (2009 - 52%); 13% (2009 - 11%); and 10% (2009 - 4%) of total sales for the year ended December 31, 2010.

## 17 Related party transactions

The Company has entered into a services agreement with Medwell Capital (Medwell), formerly BioMS Medical Corp., which owns approximately 37% of the outstanding common shares of Spectral. The services agreement is for the provision of various consulting services to assist the Company in its commercialization activities. Under the terms of the agreement, Medwell is paid \$1,000 per annum, plus applicable expenses, over three years effective January 1, 2010. As at December 31, 2010, the amount owing to Medwell was \$121 and was paid in the subsequent year.

# **Spectral Diagnostics Inc.**

Notes to Financial Statements

**December 31, 2010 and 2009**

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

## **18 Comparative figures**

Certain comparative figures have been reclassified to conform to the financial statement presentation adopted in the current year.

# Corporate Directory

## Board of Directors

R. Ian Lennox  
Chairman

Paul Walker

Anthony Bihl

Kevin Giese

Edward McCormack

Guillermo Herrera

Laine Woollard

## Management

Paul Walker, M.D., Ph.D.  
President and Chief Executive Officer

Anthony Businskas, C.A.  
Executive Vice President & CFO

Robert Verhagen, B.Sc., MBA  
Vice-President, Business Development

Debra M. Foster, RN, B.Sc., CCRC  
Vice President, Clinical Development

## Solicitors

Stikeman Elliott LLP  
5300 Commerce Court West  
199 Bay Street  
Toronto, ON M5L 1B9

## Auditors

Pricewaterhouse Coopers LLP  
Royal Trust Tower, Toronto-Dominion Centre  
77 King Street West, Suite 3000  
Toronto, ON M5K 1G8

## Transfer Agent

Computershare  
100 University Avenue 9<sup>th</sup> Floor  
Toronto, ON M5J 2Y1

## Corporate Office

Spectral Diagnostics Inc.  
135 The West Mall  
Toronto, ON

## Exchange Listing

Spectral Diagnostics Inc. is listed on the Toronto Stock Exchange under the symbol "SDI"

## Investor Relations Contact

Adam Peeler  
TMX Equicom  
416-815-0700 x225  
apeeler@equicomgroup.com

## Annual General Meeting

May 12<sup>th</sup> 2011 at 4:00 p.m.  
Stikeman Elliott LLP  
5300 Commerce Court West  
199 Bay Street  
Toronto, ON M5L 1B9

