



**Winning the battle against sepsis:  
The first theranostic — EAA™ & Toraymyxin**

## Third Quarter Letter to Shareholders

Dear Shareholders,

During the third quarter, we continued to make clinical progress and extended our financial runway to complete our U.S. Phase III EUPHRATES trial.

In August, we received approval from the U.S. FDA to increase the total number of clinical sites in our EUPHRATES trial from the current 15 sites, to a total of 30, including the option of adding international locations. The EUPHRATES trial is evaluating Spectral's theranostic product candidate for the treatment of patients with severe sepsis and septic shock.

Subsequent to quarter end, we announced that we are expanding our EUPHRATES trial to Canadian clinical trial sites.

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. In fact, regrettably there is one less option available after Eli Lilly announced, subsequent to quarter end, the worldwide withdrawal of Xigris, its product for the treatment of severe sepsis. Yet sepsis remains a leading cause of mortality.

One of the lessons we learned from Lilly's withdrawal of Xigris is that, for a complex disease like sepsis, it is important to identify responder patients who are most likely to benefit from the treatment being used. A potential advantage of our distinctive theranostic approach to treating this disease, in which we combine a diagnostic and a therapeutic, is that we can target patients at greatest risk and most likely to respond to treatment.

Toraymyxin has been used safely on more than 80,000 patients worldwide and, when guided by Spectral's EAA™ diagnostic, has the potential to address this large unmet medical need, with a market size in excess of \$1 billion annually in the U.S. alone.

We also made important progress in the third quarter to ensure we have the financial runway to complete our Phase III trial, which we currently anticipate will occur around the end of 2013.

In conjunction with Medwell Capital Corp. (TSX-V: MWC), we announced during the quarter that the two companies completed a plan of arrangement pursuant to which Medwell acquired a further 33,333,333 Spectral common shares for \$10 million, at a subscription price of \$0.30 per share. As part of the transaction, Medwell also distributed 54,282,834 Spectral shares to its shareholders. Consequently, we now have a significantly broader shareholder base with no one large controlling shareholder, and \$20 million in cash and cash equivalents in the bank at the end of the reporting period.

We feel that the advancements we made during the third quarter move us closer to our goal of providing North American patients with an effective treatment for septic shock. Our focus is to complete the EUPHRATES trial successfully and on a timely basis.

I would like to thank our shareholders for your continuing support and I look forward to updating you on the progress of the EUPHRATES trial.

Sincerely,

*Dr. Paul Walker*

President & CEO

## **MANAGEMENT'S DISCUSSION & ANALYSIS**

**(All figures are expressed in thousands of Canadian dollars)**

This Management's Discussion & Analysis ("MD&A") for the nine months ended September 30, 2011 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.

This discussion should be read in conjunction with the Condensed Interim Financial Statements of the Company, and the notes thereto, for the three and nine months ended September 30, 2011 (the "Condensed Interim Financial Statements") and the Financial Statements of the Company, and the notes thereto for the years ended December 31, 2010 and 2009 (the "Annual Financial Statements"), as well as management's discussion and analysis for the year ended December 31, 2010. The Condensed Interim Financial Statements are prepared in accordance with International Financial Reporting Standards ("IFRS") and the Annual Financial Statements were prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP").

### **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; the ability to take advantage of business opportunities; the granting of necessary approvals by regulatory authorities; and, 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 International Financial Reporting Standards ("IFRS") and in accordance with International Accounting Standard ("IAS") 34, *Interim Financial Reporting*, and IFRS 1, *First-time Adoption of International Financial Reporting Standards*. Canadian GAAP was replaced by IFRS effective January 1, 2011. The accounting policies

followed in these interim financial statements are the same as those applied in the Company's interim financial statements for the period ended March 31, 2011. The Company has consistently applied the same accounting policies throughout all periods presented, as if these policies had always been in effect. Note 9 discloses the impact of the transition to IFRS on the Company's reported equity at September 30, 2010 and comprehensive loss for the three and nine months ended September 30, 2010, including the nature and effect of significant change in accounting policies from those used in the Company's financial statements for the year ended December 31, 2010.

The accounting policies applied in these condensed interim financial statements are based on IFRS effective for the year ended December 31, 2011, as issued and outstanding as of November 10, 2011, the date the Board of Directors approved the statements. Any subsequent changes to IFRS that are given effect in the Company's annual financial statements for the year ending December 31, 2011 could result in restatement of these interim financial statements, including the transition adjustments recognized on change-over to IFRS.

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 Businkas, 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 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.

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 and septic shock, 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 U.S. 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 through non-exclusive license and supply agreements. Royalty revenues are 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 U.S. 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 U.S. 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 U.S. 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 U.S. 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. These funds are being utilized primarily for the regulatory approval and initial commercial development of Toraymyxin in the U.S. market.

In October, 2010, the Company announced the initiation of its Phase III EURPHRATES 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.

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.

On May 5, 2011, the Company announced that the initial 15 clinical trial sites approved by the U.S. FDA were operational.

In August, 2011, the company received approval from the U.S. FDA to increase the total number of clinical sites in its EUPHRATES trial from the current 15, to a total of 30. International and U.S. sites may now be included in the trial. The additional sites are expected to be operational early in 2012 and will include some sites in Canada. The trial, with a primary end point of 28 day mortality, is expected to enrol approximately 360 patients. Completion of the trial is targeted for the end of 2013, with an interim analysis planned for the midpoint of the trial.

On September 9, 2011, the Company completed a \$10 million financing. Net proceeds of approximately \$9,607 will be used primarily to advance the Toraymyxin therapeutic through to the end of the Phase III EUPHRATES trial and data release. The Company believes, at this time, that it has sufficient funds to complete this clinical development program. Just over \$20 million of cash, cash equivalents and short term investments were on hand as of September 30, 2011.

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 U.S. each year. Over half of these patients have highly elevated levels of endotoxin. The U.S. market potential for this treatment is estimated at over \$ 1 billion.

## **OPERATIONS**

During the third quarter, the Company's activities continued to focus on implementation of the EUPHRATES trial in the U.S. 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. All of the initial fifteen clinical trial sites are screening patients and candidates for the additional fifteen sites are being evaluated.

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

## **OPERATING RESULTS**

### **SELECTED FINANCIAL INFORMATION**

#### **REVENUE**

Revenue for the three months ended September 30, 2011 was \$489, compared to \$759 for the same period in the preceding year. For the nine months ended September 30, 2011 revenue was \$1,802 compared to \$2,269 in 2010.

On a year to date basis, sales of the Company's EAA™ diagnostic and related instrumentation declined by \$324 compared to the first nine months of 2010. EAA™ test and instrumentation sales for 2011 are expected to remain lower for the rest of the year, due to the timing and terms of certain distribution contracts renegotiated in 2011. Reagent revenues for the first nine months of the year were consistent with 2010 levels.

Royalty revenues of \$1,280 related to the Company's Troponin I technology were 11% lower than in the first nine months in 2010. This decline was directly related to the foreign exchange impact of the strengthening Canadian dollar compared to U.S. currency and the general impact of global economic conditions. Royalty revenues for the last quarter of 2011 are expected to be consistent with prior quarters.

#### **EXPENSES**

The Company continues to maintain a low cost operating structure and has not experienced a material increase in operating costs for its base business in 2011.

Under IFRS, expenses can be reported either by "nature" or by "function". The Company chose to report its operating expenses by "nature". Previously, expenses were reported by "function". As a result, gross margin is no longer measured, nor is it considered to be a "key performance indicator", due to the Company's strategic focus on the EUPHRATES trial.

Employee benefits in the first nine months of 2011 were \$1,954, \$415 lower than for the same period in 2010. Stock option expense in the first nine months of 2011 declined by \$638, from \$792 of stock option expense recorded in the same 2010 period. In the first quarter of 2011, 1,255,000 stock options were granted to directors, officers and employees, compared to 1,950,000 stock options granted during the same period in 2010. Other employee benefit costs in the nine month period ended September 30, 2011 were \$223 higher than in 2010 due to the addition of several clinical staff and general compensation increases for employees and directors.

EUPHRATES trial costs (as disclosed in note 5 of the Condensed Interim Financial Statements) were \$2,025 in the first nine months of 2011, compared to \$1,525 for the same period in 2010. Trial costs include clinical site qualification and initiation, contract research organization fees and expenses, patient enrolment costs, EAA™ instrumentation and tests and ongoing management of the trial. The higher expenses in 2011 reflect the normal progression of the trial. Clinical trial costs are estimated to approximate \$3,000 in 2011 and will increase in 2012 when the additional 15 sites are initiated and begin to enrol patients.

The \$1,125 of service fees was paid to Medwell Capital Corp. The Company signed a three year contract with Medwell, effective January 1, 2010, whereby Medwell provides consulting services and resources to Spectral, as required, to assist the Company in the regulatory and commercialization process for Toramyxin. Medwell was paid \$1,000 per annum (\$250 per quarter), plus applicable expenses until December 31, 2010, and is paid \$1,500 per annum (\$375 per quarter), plus applicable expenses, for the remaining two years of the contract.

Interest expense was Nil for the nine months ended September 30, 2011, compared to \$123 for the same period ended in 2010. Interest expense 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 in 2010.

Other income represents interest earned on Company's investment in cash equivalents. Investment income represents interest earned on the company's short-term investment.

## 2011 PLAN OF ARRANGEMENT

On September 9, 2011, the Company and Medwell Capital Corp. ("Medwell") concluded their plan of arrangement, whereby Medwell acquired a further 33,333,333 Spectral common shares for \$10 million cash, at a subscription price of \$0.30 per share. The Company received, after all transaction costs, net proceeds of \$9,607, which will be used primarily to advance the Toraymyxin therapeutic through to the end of the Phase III EUPHRATES trial and data release. As part of this transaction, Medwell distributed 54,282,834 Spectral shares directly to its shareholders. Medwell now holds 15,200,000 Spectral shares, representing approximately 13.4 % of the Spectral's issued and outstanding capital (calculated on a non diluted basis). Medwell also holds 15,200,000 Spectral warrants, which are exercisable at \$0.60 and expire on March 2, 2012.

## 2010 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 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. Following conversion, these notes were cancelled.

On December 31, 2010, the Company issued a further 4,648,512 common shares to three note holders, 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, cash equivalents, and short-term investments of \$20,249 as at September 30, 2011 (December 31, 2010 - \$15,332) increased by \$4,917. This increase is attributable to the following cash utilization:

Net proceeds of private placement	9,607
Cash operating losses	(4,356)
Working capital changes	(294)
Purchases of property, plant and equipment	(40)
	<u>\$4,917</u>

## **OUTLOOK**

The Company will continue to generate revenues in 2011 pursuant to its existing commercial arrangements for EAA™ and its proprietary biological reagents. The strategic focus for the next several years will be on the successful implementation of the EUPHRATES trial. Fifteen clinical sites are now screening patients and enrolment is underway. The Company expects to initiate the additional 15 sites that were recently approved by the U.S. FDA by early next year. Interim results are anticipated at the midpoint of the trial around the end of 2012.

## **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 marketing of the EAA™ products and their market acceptance
- reliance on key distributors to market and sell products in the U.S. 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 U.S. dollars and Euros and are subject to fluctuations 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 in accordance with IFRS. The Company has identified the accounting policies and estimates that are critical to the understanding of the Company's operation and financial results in the Financial Statements. Certain policies are selected by management and approved by the Finance and Audit Committee of the Board of Directors. These policies are set out in note 3 to the Condensed Interim Financial Statements for the period ended March 31, 2011. 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 Condensed Interim 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. The Condensed Interim Financial Statements of the Company have been prepared using similar estimation methods for the critical accounting estimates as were used for the Annual Financial statements and they conform to the requirements of IAS 34 "Interim Financial Reporting".

## **INTERNATIONAL FINANCIAL REPORTING STANDARDS**

IFRS employs a conceptual framework that is similar to Canadian GAAP. However, significant differences exist in certain matters of recognition, measurement and disclosure. While adoption of IFRS has not changed the Company's actual cash flows, it has resulted in changes to the Company's reported financial position and results of operations. In order to allow the users of the financial statements to better understand these changes, the Company's Canadian GAAP statement of loss and comprehensive loss, statement of financial position and statement of cash flows for the quarter ended March 31, 2010 and the year ended December 31, 2010 have been reconciled to IFRS, with the resulting differences explained, and are disclosed in note 10 of the Condensed Interim Financial Statements for the period ended March 31, 2011.

The impact of the transition to IFRS on the Company's reported equity at September 30, 2010 and comprehensive loss for the three and nine months ended September 30, 2010, including the nature and effect of significant change in accounting policies from those used in the Company's Financial Statements for the year ended December 31, 2010, is disclosed in note 9 to the Company's Condensed Interim Financial Statements for the period ended September 30, 2011.

## **IFRS 1** *First-time Adoption of International Financial Reporting Standards*

Upon transition to IFRS, effective January 1, 2010, the Company has applied IFRS 1 in preparation of the financial statements with retroactive application. This standard allows for certain optional exemptions and mandatory exceptions, in certain areas, to the general requirement for full retroactive application of IFRS.

The most significant exemption applicable to the Company is:

IFRS 1 permits the Company to elect not to apply IFRS 2 “Share Base Payments”, to equity instruments granted on or before November 7, 2002 or equity instruments that were granted subsequent to November 7, 2002 and vested before the date of transition to IFRS. The Company has elected not to apply IFRS 2 to awards that vested prior to January 1, 2010. The financial impact of making this election has not been quantified.

IFRS 1 also outlines specific guidelines that a first-time adopter must adhere to under certain circumstances. The Company has applied the following guidelines to its opening statement of financial position dated January 1, 2010:

*i. Estimates*

In accordance with IFRS 1, an entity's estimates under IFRS at the date of transition to IFRS must be consistent with estimates made for the same date under previous GAAP, unless there is objective evidence that those estimates were in error. The Company's IFRS estimates as of January 1, 2010 are consistent with its Canadian GAAP estimates for the same date.

*ii. Financial instruments*

IFRS 1 permits the re-designation in classification of previously recognized financial instruments as set out in International Accounting Standards (“IAS”) 39 *Financial Instruments, Recognition and Measurement*. The Company will continue with the previous GAAP financial instrument classifications under IFRS.

The following Standards and Interpretations have been adopted in the current period and have affected the amounts and disclosures reported in the Interim Financial Statements.

### **IAS 1** *Presentation of Financial Statements*

IAS 1 introduced terminology changes (including revised titles for the financial statements) and changes in the format and content of the financial statements. In addition, the Standard has required the presentation of a third statement of financial position at January 1, 2010.

The statement of cash flows may be presented by using the “direct” or “indirect” method. Interest paid or received can be presented as either operating or financing activities. The Company has adopted the “indirect” method. There is no impact of this change in the presentation of the financial statements. The statement of loss and comprehensive loss can be presented either by “function” or by “nature”. The Company will use the by “nature” method.

### **IAS 16** *Property, Plant and Equipment*

The standard permits assets to be measured based on either a cost model or a revaluation model. The Company currently applies the cost model and will continue to do so under IFRS and, as such, there are no significant changes to the Condensed Interim Financial Statements.

### **IFRS 2** *Share based payments*

Under IFRS, each tranche of an award with different vesting dates is considered a separate grant for the calculation of fair value, and the resulting fair value is amortized over the vesting period of the respective tranches. Forfeiture estimates are recognized in the period they are estimated, and are revised for actual forfeitures in subsequent periods.

Previously, under Canadian GAAP, the fair value of stock-based awards with graded vesting was calculated as one grant and the resulting fair value was recognized on a straight-line basis over the vesting period. Forfeitures of awards were recognized as they occur.

#### **IAS 2 Inventories**

The standard allows either the first-in first-out (FIFO) or the weighted average method for determining inventory value. The Company chose to continue with using the "weighted average" method. Accordingly, there is no financial statement impact with the adoption of this policy.

#### **IAS 18 Revenue**

Under IFRS, milestone payments are recorded as income when received. *Receipts for* instrumentation supplied to customers, where all the risks and benefits of ownership are transferred, are recorded as revenue and the related cost of the instrumentation is expensed in the same period. The impact of this policy change was not significant and has been disclosed in the reconciliation of Canadian GAAP to IFRS in note 10 to the financial statements.

#### **IAS 36 Impairment of Assets**

The standard requires impairment to be assessed using discounted estimated future cash flows. The Company does not anticipate any significant changes to the financial statements as a result of this standard.

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 statements 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 affects 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 "fair value through profit or loss" 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 September 30, 2011 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. 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 U.S. dollars and Euros. At September 30, 2011, cash included \$81 USD. Accounts receivable included a total of \$380 USD and 25 Euros. Accounts payable and accrued liabilities included a total of \$527 USD and 20€ 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 U.S./CDN or EURO/CDN exchange rate on the September 30, 2011 amounts would have a \$44 impact on operating loss.

## **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 "fair value through profit or loss" are recorded in earnings (loss) in the period in which they arise. The Company designates financial assets and financial liabilities as "fair value through profit or loss" 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 "fair value through profit or loss" 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 "fair value through profit or loss" 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.

#### **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. Milestone payments received for a license with no further performance obligation to the Company are recognized as revenue when they are receivable under the terms of the contract and when receipt is probable. 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.

#### **INCOME TAXES**

As at September 30, 2011, the Company has approximately \$20,000 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 was completely amortized as of September 30, 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 U.S. for Toraymyxin. This amount is amortized over the remaining term of the license, unless there is a permanent impairment in value, in which case it will be written off.

# **Spectral Diagnostics Inc.**

Condensed Interim Financial Statements

**September 30, 2011**

(Unaudited)

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

# Spectral Diagnostics Inc.

Condensed Interim Statement of Financial Position  
(unaudited)

(in thousands of Canadian dollars)

	Note	September 30 2011 \$	December 31 2010 \$
<b>Assets</b>			
<b>Current assets</b>			
Cash and cash equivalents		15,196	10,311
Short-term investment		5,053	5,021
Trade and other receivables		631	595
Inventories		240	209
Prepayments		66	31
		<u>21,186</u>	<u>16,167</u>
<b>Non-current assets</b>			
Property, plant and equipment		439	526
Intangible assets		466	602
		<u>905</u>	<u>1,128</u>
<b>Total assets</b>		<u>22,091</u>	<u>17,295</u>
<b>Liabilities</b>			
<b>Current liabilities</b>			
Trade and other payables		1,206	1,322
Deferred revenue		25	101
<b>Total liabilities</b>		<u>1,231</u>	<u>1,423</u>
<b>Equity</b>			
Share capital	7, 8	27,145	17,538
Contributed surplus		3,696	3,696
Other equity reserves	7	8,187	8,033
Deficit		(18,168)	(13,395)
		<u>20,860</u>	<u>15,872</u>
<b>Total liabilities and equity</b>		<u>22,091</u>	<u>17,295</u>

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

# Spectral Diagnostics Inc.

Condensed Interim Statement of Loss and Comprehensive Loss  
For the three and nine months ended September 30, 2011 and 2010  
(unaudited)

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

	Note	Three months ended September 30		Nine months ended September 30	
		2011 \$	2010 \$	2011 \$	2010 \$
<b>Revenue</b>		489	759	1,802	2,269
Other income		19	22	69	30
<b>Expenses</b>					
Changes in inventories of finished goods and work in progress		63	102	224	303
Raw materials and consumables used		59	68	153	157
Employee benefits	4, 6	558	503	1,954	2,369
Consulting and professional fees		700	585	2,040	1,699
Management services	7, 8	375	250	1,125	750
Regulatory and investor relations		68	63	212	171
Travel and entertainment		176	146	422	395
Depreciation and amortization		49	162	263	477
Foreign exchange (gain)loss		(18)	35	(1)	48
Other expenses		110	97	301	309
		2,140	2,011	6,693	6,678
<b>Operating loss</b>		(1,632)	(1,230)	(4,822)	(4,379)
Interest on convertible notes payable	7	-	(41)	-	(123)
Investment income		17	14	49	14
<b>Loss and comprehensive loss for the period</b>		(1,615)	(1,257)	(4,773)	(4,488)
<b>Basic and diluted loss per common share</b>		(0.02)	(0.02)	(0.06)	(0.07)
<b>Weighted average number of common shares outstanding</b>		88,158,757	75,844,484	83,114,164	64,281,721

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

# Spectral Diagnostics Inc.

Condensed Interim Statement of Changes in Equity  
For the nine months ended September 30, 2011 and 2010  
(unaudited)

(in thousands of Canadian dollars, except number of shares)

	Note	Issued capital Number	\$	Contributed surplus \$	Other equity reserves \$	Deficit \$	Total equity \$
<b>Balance, January 1, 2010</b>		24,118,424	2,524	3,696	2,098	(6,897)	1,421
Private placement	7	48,750,000	12,465		5,143		17,608
Settlement of convertible notes payable	7	2,890,625	1,156				1,156
Stock options exercised		142,500	49				49
Loss and comprehensive loss for the period						(4,488)	(4,488)
Share-based compensation	4, 6				792		792
<b>Balance, September 30, 2010</b>		75,901,549	16,194	3,696	8,033	(11,385)	16,538
Settlement of convertible notes payable	7	4,648,512	1,344				1,344
Loss and comprehensive loss for the period						(2,010)	(2,010)
<b>Balance, December 31, 2010</b>		80,550,061	17,538	3,696	8,033	(13,395)	15,872
Loss and comprehensive loss for the period						(4,773)	(4,773)
Private placement	7	33,333,333	9,607				9,607
Share-based compensation	4, 6				154		154
<b>Balance, September 30, 2011</b>		113,883,394	27,145	3,696	8,187	(18,168)	20,860

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

# Spectral Diagnostics Inc.

Condensed Interim Statement of Cash Flows

For the nine months ended September 30, 2011 and 2010

(unaudited)

(in thousands of Canadian dollars)

	Note	Nine months ended September 30	
		2011	2010
		\$	\$
<b>Cash flow provided by (used in)</b>			
<b>Operating activities</b>			
Loss and comprehensive loss for the period		(4,773)	(4,488)
Adjustments for:			
Depreciation on property, plant, and equipment		127	113
Amortization of intangible assets		136	364
Share-based compensation	4, 6	154	792
Interest on convertible notes payable	7	-	123
Changes in items of working capital :			
Trade and other receivables		(36)	27
Inventories		(31)	(128)
Prepayments		(35)	(40)
Trade and other payables		(116)	(306)
Deferred revenue		(76)	(78)
<b>Net cash generated from operating activities</b>		<b>(4,650)</b>	<b>(3,621)</b>
<b>Investing activities</b>			
Short-term investment		(32)	(5,000)
Property, plant and equipment expenditures		(40)	(125)
Intangible assets expenditures		-	(502)
<b>Net cash generated from financing activities</b>		<b>(72)</b>	<b>(5,627)</b>
<b>Financing activities</b>			
Private placement	7	9,607	17,608
Stock options exercised		-	49
<b>Net cash generated from financing activities</b>		<b>9,607</b>	<b>17,657</b>
<b>Increase in cash and cash equivalents</b>		<b>4,885</b>	<b>8,409</b>
<b>Cash and cash equivalents, beginning of period</b>		<b>10,311</b>	<b>2,944</b>
<b>Cash and cash equivalents, end of period</b>		<b>15,196</b>	<b>11,353</b>

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

# Spectral Diagnostics Inc.

Notes to the Condensed Interim Financial Statements

For the three and nine months ended September 30, 2011 and 2010

(unaudited)

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(in thousands of Canadian dollars, except for 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 underway at fifteen sites and is expected to take approximately two years to complete. An additional fifteen international sites will be operational by the end of the first quarter of 2012. All costs related to this regulatory approval process are described in Note 5.

## 2. Basis of preparation and adoption of IFRS

The Company prepares its financial statements in accordance with Canadian generally accepted accounting principles as set out in the Handbook of the Canadian Institute of Chartered Accountants ("CICA Handbook"). In 2010, the CICA Handbook was revised to incorporate International Financial Reporting Standards, and require publicly accountable enterprises to apply such standards effective for years beginning on or after January 1, 2011. Accordingly, the Company has commenced reporting on this basis in its 2011 condensed interim financial statements. In these financial statements, the term "Canadian GAAP" refers to Canadian GAAP before the adoption of IFRS.

These condensed interim financial statements have been prepared in accordance with IFRS applicable to the preparation of interim financial statements, including IAS 34, *Interim Financial Reporting*, and IFRS 1, *First-time Adoption of International Financial Reporting Standards*. The accounting policies followed in these interim financial statements are the same as those applied in the Company's condensed interim financial statements for the period ended March 31, 2011. The Company has consistently applied the same accounting policies throughout all periods presented, as if these policies had always been in effect. Note 9 discloses the impact of the transition to IFRS on the Company's reported equity at September 30, 2010 and comprehensive loss for the three and nine months ended September 30, 2010, including the nature and effect of significant change in accounting policies from those used in the Company's financial statements for the year ended December 31, 2010.

The accounting policies applied in these condensed interim financial statements are based on IFRS effective for the year ended December 31, 2011, as issued and outstanding as of November 10, 2011, the date the Board of Directors approved the statements. Any subsequent changes to IFRS that are given effect in the Company's annual financial statements for the year ending December 31, 2011 could result in restatement of these interim financial statements, including the transition adjustments recognized on change-over to IFRS.

The condensed interim financial statements should be read in conjunction with the Company's Canadian GAAP annual financial statements for the year ended December 31, 2010, and the Company's condensed interim financial statements for the quarter ended March 31, 2011 prepared in accordance with IFRS applicable to condensed interim financial statements.

# Spectral Diagnostics Inc.

Notes to the Condensed Interim Financial Statements

For the three and nine months ended September 30, 2011 and 2010

(unaudited)

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

## 3. Commitments

The Company has committed to expenditures of approximately \$18 million over the next two years for its U.S. pivotal trial.

## 4. Share-based payments

- i. The Company granted the following options to directors, officers, employees and others at the discretion of the Board of Directors.

September 30, 2011			September 30, 2010		
Date	Number of options	Exercise price	Date	Number of options	Exercise price
March 15 2011	1,255,000	\$0.315	February 26 2010	1,800,000	\$0.40
			March 10 2010	150,000	\$0.60

The exercise prices of the options are equal to the closing market price of the Company's shares on the Toronto Stock Exchange on the day immediately preceding the day of the grant of the option. Options issued to the Company's directors were vested at the time of the grant. Options issued to the Company's employees vested at 25% of the grant amount at the time of the grant. The balance of the employee options vest equally in each successive quarter and will be fully vested by March 14, 2014. The contractual life of each option is five years. There is no cash settlement of the options.

	2011	2010
Risk-free interest rate	2.54%	2.50%
Expected life	5 years	5 years
Annualized volatility	95.25%	105.00%
Dividend rate	0%	0%
Grant date fair value	\$0.32	\$0.41

The volatility measured at the standard deviation of continuously compounded share returns is based on statistical analysis of weekly share prices over the last five years.

- ii. The Company issued broker warrants to Desjardins Securities Inc., in exchange for services performed in connection with the private placement financing as described in Note 7. The warrants will entitle Desjardins 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 fair value of the transaction was measured by the fair value of the brokers warrants granted using the Black-Scholes options pricing model with weighted average assumptions as follows:

# Spectral Diagnostics Inc.

Notes to the Condensed Interim Financial Statements

For the three and nine months ended September 30, 2011 and 2010

(unaudited)

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

	<b>2010</b>
Risk-free interest rate	2.34%
Expected life	4 years
Annualized volatility	105.00%
Dividend rate	0%
Grant date fair value	\$0.50

The volatility measured at the standard deviation of continuously compounded share returns is based on statistical analysis of weekly share prices over the last five years.

## 5. The EUPHRATES trial

The EUPHRATES (Evaluating the Use of Polymyxin B Hemoperfusion in a Randomized controlled trial of Adults Treated for Endotoxemia and Septic shock) trial is a randomized, double-blind control trial of standard of care versus standard of care and Toraymyxin, directed by Spectral's Endotoxin Activity Assay (EAA™), an FDA cleared assay for use in sepsis.

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

	Three months ended		Nine months ended	
	September 30		September 30	
	2011	2010	2011	2010
	\$	\$	\$	\$
Pre-trial costs	-	-	-	321
Program management	461	366	1,197	878
Data safety monitoring	76	31	475	55
Diagnostic supply and training	39	69	43	74
Other	41	-	73	-
Employee benefits	71	81	237	197
	688	547	2,025	1,204
	688	547	2,025	1,525

The trial costs have been included in the statement of loss and comprehensive loss in their respective expense categories.

# Spectral Diagnostics Inc.

Notes to the Condensed Interim Financial Statements

For the three and nine months ended September 30, 2011 and 2010

(unaudited)

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

## 6. Compensation

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

	Three months ended		Nine months ended	
	September 30		September 30	
	2011	2010	2011	2010
	\$	\$	\$	\$
Salaries and short term employee benefits	288	225	875	679
Directors fees	53	36	192	124
Post-employment benefits	-	-	44	42
Share based payments	11	-	136	692
	352	261	1,247	1,537

## 7. Financing

i. On September 9, 2011, the Company and Medwell Capital Corp. ("Medwell") concluded their plan of arrangement, whereby Medwell acquired a further 33,333,333 Spectral common shares for \$10 million cash, at a subscription price of \$0.30 per share. The Company received, after all transaction costs, net proceeds of \$9,607, which will be used primarily to advance the Toraymyxin therapeutic through to the end of the Phase III EUPHRATES trial and data release.

As part of this transaction, Medwell distributed 54,282,834 Spectral shares directly to its shareholders. Medwell now holds 15,200,000 Spectral shares, representing approximately 13.4 % of the Spectral's issued and outstanding capital (calculated on a non-diluted basis). Medwell also holds 15,200,000 Spectral warrants, which are exercisable at \$0.60 and expire on March 2, 2012.

ii. 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, entitling 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 fair value of the options granted was \$596 and has been adjusted to other equity reserves.

# Spectral Diagnostics Inc.

Notes to the Condensed Interim Financial Statements

For the three and nine months ended September 30, 2011 and 2010

(unaudited)

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

The Company 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.

## 8. Related party transactions

The Company has entered into a services agreement with Medwell Capital ("Medwell"), formerly BioMS Medical Corp., which entity owns approximately 13.4% (2010-45%) of the outstanding common shares of Spectral. The agreement, effective January 1, 2010, is for the provision of various consulting services to assist the Company in its commercialization activities. Under the terms of the agreement, Medwell was paid \$1,000 per annum, plus applicable expenses, until December 31, 2010, and is paid \$1,500 per annum plus applicable expenses, commencing January 1, 2011, over the remaining two years of the contract.

As at September 30, 2011, the amount owing to Medwell was \$157 (2010-\$99) and was paid in the subsequent period.

## 9. Transition to IFRS

IFRS employs a conceptual framework that is similar to Canadian GAAP. However, significant differences exist in certain matters of recognition, measurement and disclosure. While adoption of IFRS has not changed the Company's actual cash flows, it has resulted in changes to the Company's reported financial position and results of operations. In order to allow the users of the financial statements to better understand these changes, the Company's Canadian GAAP statement of comprehensive loss, statement of financial position and statement of cash flows for the three and nine months ended September 30, 2010 and the year ended December 31, 2010 have been reconciled to IFRS:

# Spectral Diagnostics Inc.

Notes to the Condensed Interim Financial Statements

For the three and nine months ended September 30, 2011 and 2010

(unaudited)

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

Reconciliation of loss and comprehensive loss as previously reported under Canadian GAAP to IFRS

	Three months ended September 30 2010			Nine months ended September 30 2010		
	Cdn GAAP	Adj	IFRS	Cdn GAAP	Adj	IFRS
	\$	\$	\$	\$	\$	\$
<b>Revenue</b>	722	37	759	2,148	121	2,269
Cost of Sales	138	45	183	457	120	577
<b>Gross margin</b>	584	(8)	577	1,691	1	1,692
<b>Operating expenses</b>						
Selling, general and administrative	850	-	850	2,511	-	2,511
Clinical trial	532	-	532	1,500	-	1,500
Service fees	250	-	250	750	-	750
Amortization	161	-	161	476	-	476
Foreign exchange loss	35	-	35	48	-	48
Stock-based compensation	-	-	-	792	-	792
Research and development, net of tax credits	-	-	-	24	-	24
	1,828	-	1,828	6,101	-	6,101
<b>Loss before the following</b>	(1,244)	(8)	(1,252)	(4,410)	1	(4,409)
Interest on convertible notes payable	(41)	-	(41)	(123)	-	(123)
Other net investment income	36	-	36	44	-	44
<b>Loss and comprehensive loss for the period</b>	(1,249)	(8)	(1,257)	(4,489)	1	(4,488)
<b>Deficit-beginning of period</b>	(10,193)	65	(10,128)	(6,953)	56	(6,897)
<b>Deficit-end of period</b>	(11,442)	57	(11,385)	(11,442)	57	(11,385)
<b>Basic and diluted loss per common share</b>	(0.02)		(0.02)	(0.07)		(0.07)
<b>Weighted average number of common shares outstanding</b>	75,844,484		75,844,484	64,281,721		64,281,721

SPECTRAL |   
*Diagnostics*

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