# 2015 Annual Report

**Creating the Improved Standard in Healthcare Sterile Reprocessing™**

## Contents

# Message from the Chairman of the Board

Dear Shareholders,

As Chairman of the Board of $TSO_3$, I am pleased to once again report that the Company demonstrated solid performance during fiscal year 2015. During the year, the Board was involved in a wide variety of discussions. Of note were the exchanges between Board Members and management that lead to the ratified Exclusive Distribution Agreement with Getinge Infection Control; a significant accomplishment for both Companies.

With the significant positive change that occurred within the Company throughout the year, the Board through use of established practices and policies kept a watchful eye on investor communications assuring that these communications met both the requirements of compliance with applicable law and the standards for transparency.

As is required from time to time, during 2015, the Board said a heartfelt thank you and goodbye to two long standing members while renewing itself with the introduction of two new members having significant expertise. During the year the Human Resource Committee of the Board was particularly engaged with management as the Company sought to strengthen its leadership team.

As we look ahead, the Board is enthusiastic about the Company's vision of the future and our role providing governance and oversight to management as they march towards their goals. We see the opportunity and the global need for the Company's technology, product and skills and look forward to representing the interest of the Company's Stakeholders in pursuit of this vision.

Germain Carrière

Germain Carrière

The Company demonstrated solid performance during fiscal year 2015!

The Board was involved in a wide variety of discussions.

The Board is enthusiastic about the Company's vision of the future and our role providing governance and oversight to management.

## Message from the Chief Executive Officer

Dear Shareholders:

Normally, I would attempt to provide a quick narrative of the key events of the year, but this year quite honestly there is just too much to review so for this year I will simply summarize.

At a glance:

- Signed non-exclusive sales agency agreement in April with Getinge
- Initiated commercial activities alone and together with sales agent
- Installed first STERIZONE® VP4 sterilizers in the USA
- Signed Exclusive worldwide distribution agreement with Getinge Infection Control in November
  - Performance minimums
  - $7.5M (USD) upfront license fee
- Modified Health Canada license to allow sterilization of long multi-channeled complex endoscopes
  - Verified claim applicable to European market
- Added to management strength with announcement of new CFO
- Accepted initial purchase orders for sterilizers and accessories for delivery in 2016
- Increased our assembly resources to meet demand
- Applied for extended lumen claims in the US market

What a great year!

My thanks to the dedicated employees that made this happen!

In the third quarter, $TSO_3$ did initiate sales to the US of its STERIZONE® VP4 Sterilizer. In fourth quarter the Company did not fill orders received; rather we decided to initiate shipments with a smooth and scheduled release process starting in January 2016.

Subsequent to year-end the Company has in fact initiated shipments. Through the first two months of 2016, the Company recorded revenues in excess of all revenues recorded in all of 2015, a clear record. These numbers and details will be reviewed shortly with the upcoming release of the first quarter's results.

R.M. (Ric) Rumble

- ✓ Signed Exclusive Worldwide Agreement
- ✓ Added Management Strength
- ✓ Accepted Record Level Order
- ✓ Initiated Shipments

Recently we received questions from the US regulators on our submission requesting an expansion to our label claims. These limited questions will require a modest amount of additional tests to help clarify our statements to the Agency. We expect our file to be on the agency's desk promptly. I just wish to add that given the extreme visibility of the challenges being faced by the industry with inappropriately processed devices such as colonoscopes and duodenoscopes; the questions received are equal to the importance of finding a sustainable solution. We are confident that $TSO_3$ is the solution.

In the meantime our current claims remain the benchmark in the healthcare sterilization. We can do more, faster, less expensively and with reduced operator error; we are simply a superior solution.

As we closed 2015 the means to enhance our balance sheet were made available and early in 2016 the Company exercised its right to accelerate warrants that had been issued as part of the cash raise earlier in 2015. The total proceeds from the warrant conversion equated to $13.5 million leaving us, at the beginning of February, with more than $32 million in cash, cash equivalents, and short-term investments when including all proceeds from warrant exercises. These resources are more than required to see the current business achieve a cash flow positive condition.

So 2015 was a great year! There is a lot to do in 2016; we believe that again this year we will substantially increase our value.

As always I would like to thank the Board of Directors for their support and guidance, our employees for their dedication and you our committed shareholders for your patience and encouragement.

R.M. (Ric) Rumble

# Overview

**Who We Are and What We Do**

$TSO_3$ Inc. was founded in June 1998 in Québec City and employs 49 people as at December 31, 2015. The Company's activities encompass the sale, production, maintenance, research, development and licensing of sterilization processes, related consumable supplies and accessories for heat-sensitive medical devices. The Company's products, which represent a significant improvement in features and efficacy over incumbent low temperature sterilization technologies, are used in the sterilization departments of hospital and other medical facilities. It also provides services related to the maintenance of sterilization equipment and compatibility testing of medical devices with such processes.

$TSO_3$ Corporation, the Company's wholly-owned subsidiary incorporated in Q2 2015, is structured under the laws of the State of Delaware and located in the State of South Carolina, USA. $TSO_3$ Corporation was established to meet U.S. customer requirements. The U.S. represents approximately 40% of the worldwide market for low-temperature sterilization equipment. The U.S. location will be used for administration, warehousing and distribution of parts and consumables, laboratory services, conducting light assembly, and providing service and education to U.S. customers.

**The First Generation Technology**

$TSO_3$ initially developed a sterilizer using a unique sterilization process based solely on ozone as the sterilizing agent. The sterilizer offered superior sterile efficacy and lower operating costs compared to competitive systems and was considered a "green" technology. However, this first generation product provided limited instrument compatibility and a relatively long sterilization cycle.

This first-generation sterilizer received regulatory clearances from both Health Canada and the U.S. Food and Drug Administration (FDA). However, the product did not address the greater market need for compatibility, fast turn-around times and high-throughput. As a result, it had limited commercial success, with only 38 units sold in North America by the Company's sales force over five years.

**A New Approach**

In December 2014, $TSO_3$ achieved a major milestone when its next-generation sterilizer, STERIZONE® VP4 Sterilizer, received 510(k) clearance from the FDA. The STERIZONE® VP4 Sterilizer developed by $TSO_3$ is a dual sterilant, low temperature sterilization system that utilizes vaporized hydrogen peroxide ($H_2O_2$) and ozone ($O_3$) as its sterilants.

The STERIZONE® 125L+ Sterilizer was licensed by Health Canada in 2009 and CE marked in 2010 and the Company subsequently sold a limited number of units in Canada as initial beta units. These initial units have been in continuous operation for more than four years. The STERIZONE® VP4 Sterilizer and its accessories, an evolution of the STERIZONE® 125L+ Sterilizer, were cleared for commercialization in the United States in December 2014.

The STERIZONE® VP4 Sterilizer includes a number of validated features such as:

- A unique patent pending *Dynamic Sterilant Delivery System™*, which automatically adjusts the quantity of injected sterilant based on the load composition and condition;
- Up to a 75 lb mixed load capacity;
- A single cycle system able to simultaneously sterilize flexible, rigid, and general medical devices in the same load, thereby eliminating cycle selection error as a cause of ineffective processing;
- A short cycle time relative to other sterilization technologies;
- The largest quantity of mixed devices per load;
- The only two or more sterilant sterilizer cleared by the US regulatory authorities;

**Extended Claims – Patient Care Improvement**

In October 2015, the STERIZONE® VP4 Sterilizer received clearance from Health Canada (Canadian equivalent of the United States FDA) to sell the STERIZONE® VP4 Sterilizer with extended claims in the Canadian market.

With these claims, the $TSO_3$ STERIZONE® VP4 Sterilizer is the only low temperature terminal sterilization system available in the market validated to sterilize complex medical instruments such as colonoscopes and other multi-channel flexible scopes, which previously could only be treated in a less effective process known as "high-level disinfection". Low temperature sterilization with the STERIZONE® VP4 Sterilizer offers a more effective solution than disinfection, since it involves a proprietary physical and chemical process that thoroughly destroys all types of microbiological organisms, including bacterial spores. Further, the STERIZONE® VP4 terminally sterilizes multiple channels in a single device, an industry first for any medical device sterilization process.

The expanded claims received for the STERIZONE® VP4 Sterilizer in Canada correspond to increasing scrutiny by regulatory authorities over medical device reprocessing, particularly for colonoscopes and other complex medical devices used during minimally invasive surgical procedures. Much of this concern stems from patient-to-patient transfer of multidrug-resistant bacteria, which are inactivated with the STERIZONE® VP4. Published reports confirm the significant risk of device-related transfer of antibiotic resistant microbes, which can lead to patient injury or death.

This Canadian, and subsequent European, clearance marks the beginning of a new and sorely needed improved-level of patient care, which is consistent with $TSO_3$'s vision. The allowance of these claims in Canada and Europe helps support the Company's pursuit of similar claims in other international markets, including the U.S., where $TSO_3$ filed studies that support an expanded indication for use of its STERIZONE® VP4 Sterilizer in December 2015.

Finally, in December 2015, $TSO_3$ added to its label claims for the STERIZONE® VP4 Sterilizer in Canada that validates the ability to terminally sterilize a specific duodenoscope. Duodenoscopes are multi-channel endoscopic devices with flexible lighted tubes that are typically threaded through the mouth, throat and stomach and into the top of the small intestine (duodenum). They are used in an increasingly common procedure called endoscopic retrograde cholangiopancreatography (ERCP). ERCP is used primarily to diagnose and treat conditions of the bile ducts and main pancreatic duct, including gallstones, inflammatory strictures (scars), leaks (from trauma and surgery) and cancer.

Duodenoscopes are complex endoscopes, with small working parts that include an elevator guide-wire mechanism that is difficult to reach when reprocessing. This is compounded by the fact that the design varies across brands and models. However, if a duodenoscope is not meticulously reprocessed, living microbes harboring in residual tissue or fluid from a prior procedure can be transmitted via the scope to a subsequent patient.

$TSO_3$ has established laboratory data that validates that the STERIZONE® VP4 Sterilizer, with its dual sterilants of hydrogen peroxide and ozone, can repeatedly sterilize the Olympus TJF-Q180V Duodenoscope, the industry's leading brand and model of duodenoscope. This breakthrough comes at a critical time, with the growing use of duodenoscopes, along with the increasing number of adverse incidents related to ineffectual reprocessing. $TSO_3$ is preparing documentation to support a U.S. FDA submission to add this device and others to its US label claims.

**Our Business Environment and the Market Drivers**

Sterile reprocessing of medical devices is essential to ensure positive surgical outcomes. The use of non-sterile surgical instruments contributes to increased infection rates and, in turn, leads to increased patient hospital stays, higher cost of care and greater mortality rates.

The world population is aging, with the fastest growing segment age 65+ expected to nearly double by 2020 from 2010, according to the United Nations. The ageing population is expected to result in increasing demand for diagnostic procedures and surgical operations involving scopes and Minimally Invasive Surgical (MIS) devices, and thereby increase demand for efficacious and high-throughput sterilization methods that can process such devices, such as low temperature terminal sterilization systems.

Today, it is not uncommon to find sterile reprocessing of instruments conducted in three areas of a hospital: the central sterile department (CS), the sub-sterile area of the operating room (OR), and the gastroenterology department (GI).

**Why Low Temperature Sterile Reprocessing**

While some medical instruments are designed for single use, the majority must be reprocessed between surgical cases and therefore need to be compatible with the sterilization process used. Traditionally, steam was used to sterilize surgical instruments.

Today's surgical suite is very different from operating rooms of the past. Currently, the trend continues towards the practice of MIS. Devices used in MIS are complex, expensive and delicate, and in most cases, do not tolerate the steam sterilization process. Instead, they require low-temperature sterilization. These high-demands, complex devices represent a major financial investment for hospitals as well as a challenge to sterilize.

**Our Competitive Landscape**

The Company competes in an industry characterized by both multinational and regional companies that market sterilization technologies. The main players in this space are STERIS Corporation, Johnson & Johnson, 3M Company, Getinge AB, and Belimed AG.

The low-temperature gas sterilization methods most commonly used today are hydrogen peroxide ($H_2O_2$) sterilization systems. These methods offer "terminal sterilization" referring to the instruments being packaged and therefore, remaining sterile until opened at the surgical site. Current $H_2O_2$ sterilization methods are fast, however they are very expensive to operate, and have limits as to efficacy and loading capacity based on their design.

Another method that played a role in a sub-segment of low temperature reprocessing was that of liquid chemical sterilization processes. This type of process was used directly in the OR as a just-in-time method to complement the CS department's sterile production. The GI department remains a heavy user of liquid chemical sterilization. Liquid systems require rinsing with treated water that cannot be assured to be sterile, and therefore instruments cannot be assured to be sterile when used on a patient.

Each of these sterilization methods offers benefits to the customers, but none is a complete solution matching the customer need for high and cost effective throughput of complex and expensive medical devices. Therefore, customers have to purchase and support a combination of products to meet their daily requirements for sterile supplies. The Company believes that its technology offers a single solution to address customer needs.

## 2015 Annual Review

**Regulatory Status**

On December 17, 2014, $TSO_3$ obtained commercial clearance to market in the United States the single-cycle STERIZONE® VP4 Sterilizer, as well as its accessories and consumables.

The clearance in the US allows the Company to sell the STERIZONE® VP4 Sterilizer in the world's largest sterilization market. The 510(k) was received with a newly assigned Product Code, which highlights the

uniqueness of the Company's technology and establishes a new benchmark in the field of low temperature sterilization.

In October 2015, $TSO_3$ obtained regulatory clearance to market in Canada the single-cycle STERIZONE® VP4 Sterilizer, along with its accessories and consumables. This is the same product currently sold in the U.S. With the Canadian introduction of the STERIZONE® VP4 Sterilizer came an increased set of claims for the device in that market, including being the only terminal low-temperature sterilization system validated to sterilize complex medical devices, such as colonoscopes and other multi-channel flexible scopes. The Company continues to pursue these claims in all markets, including the U.S.

**Recent Commercial Activities**

In March of 2015, Getinge Infection Control AB, a global leader in infection control solutions, became a sales agent of the Company's FDA-cleared, STERIZONE® VP4 Sterilizer. As a result $TSO_3$ and Getinge actively collaborated to establish a sales pipeline for the products in the United States. This activity resulted in the first shipments of our STERIZONE® VP4 Sterilizer being recorded in Q3 of 2015. Based on customer feedback and our mutual experiences with the product line, Getinge established global rollout plans with the intent of leveraging the global reach of their existing subsidiaries and distributor partnerships across six continents. On November 25, 2015, $TSO_3$ entered into an agreement with Getinge which granted their partner exclusive global distributor rights in exchange for US$7.5 million plus performance minimums.

The exclusive partnership with a top global provider of infection control devices and services represents an endorsement of the STERIZONE® Sterilization System to sterilize the most challenging loads and complex devices used in healthcare today.

The performance requirements of the agreement are multi-year and based on a formula for minimum unit shipments, with minimum annual commitments reaching in excess of 10% of the estimated annual global replacement market within the first five years. $TSO_3$ estimates the annual replacement market worldwide totals more than 3,000 units or $450 million annually. Getinge will also receive ongoing technical support from $TSO_3$ as part of the agreement.

Sales under the agreement are made on a fixed price basis in US dollars to Getinge, who will be our only customer for the STERIZONE® VP4 Sterilizer while the agreement is in force. On December 18, 2015, $TSO_3$ received a purchase order from Getinge which meets the full 2016 contractual minimum purchase amount required in the agreement.

**Cash Position**

In Q1 2015, the Company closed an equity issue consisting of 9,200,000 units in the capital of the Company at the price of $1.25 per unit for aggregate gross proceeds of $11,500,000.

Each unit was comprised of one common share and one common share purchase warrant entitling the holder thereof to acquire one common share at a price of $1.875 at any time prior to March 5, 2017. The Warrants were subject to an accelerated expiry if, at any time after September 30, 2015, the closing price of the common shares on the TSX stock exchange equalled or exceeded $2.00 for any 10 consecutive trading days.

On January 5, 2016, $TSO_3$ accelerated the expiry date of the warrants to February 4, 2016. During 2015, 0.7 million warrants were exercised for $1.3 million total proceeds. Of the 8.5 million warrants remaining subject to expiry acceleration as at January 5, 2016, 7.2 million were exercised and 1.3 million expired unexercised for $13.5 million proceeds. The total proceeds from the warrants associated with the 2015 financing equaled $14.8 million. As at February 5, 2016, the Company had more than $32 million in cash, cash equivalents, and short-term investments when including all proceeds from warrant exercises.

The compensation paid to the syndicate of underwriters was equal to a sale commission of $0.8 million, or 7% of the gross proceeds from the original equity issue, and the issuance of 460,000 compensations warrants. Each compensation warrant enables its holder to purchase one common share of the Company at the price of $1.25 until March 5, 2016. As at March 5, 2016, all compensation warrants had been exercised for total cash proceeds of $575,000.

**Intellectual Property**

In 2015, the US Patent Office and the Canadian Patent Office each granted to the Company a first patent on a core aspect of the technology embedded in the $TSO_3$ STERIZONE® Sterilization System.

Also in 2015:

- The Company has been notified by the European Patent Office of its decision to grant two additional patents covering important aspects of $TSO_3$'s technology embedded in the STERIZONE® Sterilization System. Five other previously granted European patents on distinctive innovating aspects are now in force in 11 European countries.
- Six additional Japanese patents have been granted on various aspects of $TSO_3$'s technology.
- $TSO_3$ filed new patent applications covering an additional critical aspect of $TSO_3$'s technology in US and Japan to strengthen patent protection of the STERIZONE® VP4 Sterilizer.
- Additional new US and international patent applications related to biological indicators (BI) used to monitor effectiveness of a sterilization process were filed.

Other patent applications are still pending in the United States as well as elsewhere in the world. $TSO_3$'s unique Dynamic Sterilant Delivery System™ is core to the differentiation of its products and its protection enhances the Company's value.

**Write-Off of Assets and Discontinuation of Ozone-only 125L Sterilizer**

In November 2014, the Company decided to discontinue supporting its first generation sterilizer, the 125L ozone-only Sterilizer, as well as retire its technology. As a result, at December 31, 2014, the Company wrote-off inventories and patents related to this technology. In Q1 2015, the Company completed a review of its active portfolio of patents, and wrote-off additional patents and patent applications for a net amount of $214,209. No additional write-offs have been made.

## 2016 Focus

In 2016 we expect to first focus our resources to help ensure that our channel partner meets and/or exceeds the performance objectives outlined in our mutual agreement. To this end, $TSO_3$ is targeting systems development that shall result in a robust supply chain process and deliver quality product at increasing volumes. We will work collaboratively with our partner preparing targeted international markets for full market entry later in the year and through out 2017. This will involve the support of congress work and key opinion leaders, while conducting selected studies in local markets, when and where these studies can be demonstrated to add value.

It is clear that 2016 will be the year in which revenue flow begins and $TSO_3$ is in a position to assemble and deliver in excess of 100 sterilizers. The rate of such deployment into end customers will likely be variable as new technology adoption, equipment replacement, installation and deployment cycles in hospitals are difficult to predict. Installations can take months post-delivery so a higher number of shipments are planned.

As a result, we expect revenue, gross profit and operating results to improve during the year 2016. We also expect to increase assembly, sales and administrative resources to build sterilizers and to train and support Getinge in the deployment of our sterilizers.

Additionally, we continue to invest in incremental product enhancements to our STERIZONE® VP4 Sterilizer to address local market adoption and developing new purpose-built products which leverage our *Dynamic Sterilant Delivery System™* for specific substantial but specialized market niches.

During the year $TSO_3$ anticipates to pursue and obtain expanded claims for its STERIZONE® VP4 Sterilizer in the US market. Specifically $TSO_3$ expects to obtain clearances to sterilize instruments that have previously been subject to high level disinfection processes. Such claims will further differentiate our technology and, equally important, provide todays healthcare providers a new tool to break the cycle of instrument associated to infection transmission.

Lastly, we continue to be focused on the development and commercialization of products in the sterile reprocessing market such as the STERIZONE® 80L Sterilizer. We are regularly presented with and evaluate third party complimentary technologies or product lines for potential acquisition and expect to incur expenses associated with these activities in 2016.

# Management Discussion and Analysis

The Management Discussion and Analysis (MD&A) is intended to help readers assess the consolidated financial position and consolidated financial performance of $TSO_3$ Inc. ("$TSO_3$", the "Company", "We" or "Us") for the twelve-month period ended December 31, 2015 and to compare them with the twelve-month period ended December 31, 2014. This information is dated March 22, 2016 and should be read in conjunction with the Annual Audited Financial Statements and the accompanying notes. Unless specified otherwise, all amounts are stated in Canadian dollars.

The financial information contained in this MD&A and in the Annual Audited Consolidated Financial Statements has been prepared in accordance with the International Financial Reporting Standards ("IFRS"). We occasionally refer to non-IFRS financial measures in the MD&A. See the Non-IFRS financial measures section for more information.

The Annual Audited Consolidated Financial Statements, accompanying notes and MD&A have been reviewed by the Audit and Risk Management Committee of $TSO_3$ and approved by the Board of Directors.

# Forward Looking Statements

Certain statements contained in this annual report and the MD&A constitute forward-looking statements. These statements relate to future events or the Company's future performance, business prospects or opportunities and product development. All statements other than statements of historical facts may be forward-looking statements. Forward-looking statements are often, but not always, identified by the use of words such as "seek", "anticipate", "plan", "continue", "estimate", "expect, "may", "will", "project", "predict", "potential", "targeting", "intend", "could", "might", "should", "believe" and similar expressions. These statements involve known and unknown risks, uncertainties and other factors that may cause actual results or events to differ materially from those anticipated in such forward-looking statements.

The Company believes that the expectations reflected in these forward-looking statements are reasonable, but no assurance can be given that these expectations will prove to be correct. These statements speak only as of the date of this report. Such statements are based on a number of assumptions which may prove to be incorrect, including, but not limited to, assumptions about:

- Business and economic conditions;
- The ability to obtain sufficient quantities of supplies and materials when needed;
- The ability to obtain regulatory authorizations to market its product;
- The ability to attract and retain skilled staff;
- Market competition;
- Tax benefits and tax rates;
- The ability to complete research and development work;
- The ability for the Company to market its products;
- The success of the relationship with Getinge Infection Control and suppliers;
- The ability for Getinge to deploy our products to end customers;
- Foreign currency exchange rates;
- The ability for the Company to attract capital.

These forward-looking statements involve risks and uncertainties relating to, among other things, commercial operations, compatibility, biocompatibility, research and development projects, dependency on key personnel, management of business growth, intellectual property and counterfeiting, competition, product liability issues, litigation, regulatory approvals and financial instruments. Actual results and developments are likely to differ, and may differ materially, from those expressed or implied by the forward-looking statements. Factors that could cause actual results to differ materially include, but are not limited to, the risk factors described under the section “Risk factors” of this report.

Investors should not place undue reliance on forward-looking statements as the plans, intentions or expectations upon which they are based might not occur. The Company cautions that the foregoing list of risk factors is not exhaustive. Investors and others who base themselves on the Company's forward-looking statements should carefully consider the above factors as well as the uncertainties they represent and the risk they entail. The reader must not unduly rely upon the Company’s prospective statements.

Further, the Company does not intend, and does not assume any obligation, to update these forward looking statements, except as may be required by applicable laws.

## Non-IFRS Financial Measures

This MD&A was prepared using results and financial information determined under IFRS. In addition to IFRS financial measures, management uses non-IFRS measures to assess the Company’s operational performance. It is likely that the non-IFRS financial measures used by the Company will not be comparable to similar measures reported by other issuers or those used by financial analysts as their measures may have different definitions. The measures used by the Company are intended to provide additional information and should not be considered in isolation or as a substitute for IFRS financial performance measures.

Generally, a non-IFRS financial measure is a numerical measure of an entity’s historical or future financial performance, financial position or cash flows that is neither calculated nor recognized under IFRS. Management believes that such non-IFRS financial measures are important as they provide users of the Financial Statements with a better understanding of the results of the Company’s recurring operations and their related trends, while increasing transparency and clarity into its operating results. Management also believes these measures can be useful in assessing the Company’s capacity to discharge its financial obligations.

By excluding from its results the items that arise mainly from long-term strategic decisions and/or do not, in management’s opinion, reflect the Company’s operating performance for the period, such as (1) the write-off of tangible and intangible assets, (2) research and development tax credits, whose recognition is volatile, varies with changes in tax laws, or may not match the timing of related eligible expenditures, and (3) other significant unusual items, management believes this MD&A helps users to better analyze the Company’s results and ability to discharge its obligations as they become due. Furthermore, the use of non-IFRS measures helps users by enabling better comparability of results from one period to another and better comparability with other businesses in the Company’s industry.

The non-IFRS measures that the Company uses to assess its operational performance include (1) adjustments in operating expenses designed to enable comparison of results from one period to another, and (2) a measure for the rate at which the Company is using its cash resources. Management believes these measures to be useful in assessing the Company’s capacity to discharge its current and future financial obligations.

## Summary of Results

Periods ended December 31 (Audited, IFRS Basis, CAD$ except share amounts)

| | **2015** | 2014 |
|---|---|---|
| | **$** | $ |
| **Sales** | **1,633,244** | 432,987 |
| **Expenses** | | |
| Supply Chain | **2,056,571** | 1,118,498 |
| Marketing, Sales and Service | **851,034** | 301,763 |
| Research and Development | **2,808,041** | 2,333,113 |
| Administrative | **4,228,403** | 2,720,249 |
| Financial | **(177,343)** | (92,647) |
| **Total Expenses** | **9,766,706** | 6,380,976 |
| **Net Loss before Income Taxes** | **8,133,462** | 5,947,989 |
| **IncomeTaxes** | **-** | - |
| **Net Loss and Comprehensive Loss attributable to Shareholders** | **8,133,462** | 5,947,989 |
| Basic and Diluted Net Loss per Share | **0.10** | 0.08 |
| Weighted Average Number of Outstanding Shares | **81,263,710** | 73,123,794 |

## Results Analysis

In the following paragraphs, we discuss the variations of certain accounts within the annual periods ended December 31, 2015 and 2014.

### SALES

For the 2015 fiscal year, sales amounted to $1.6 million, as compared to $0.4 million in 2014. The higher sales in 2015 were the result of sales of the new STERIZONE® VP4 Sterilizer to Getinge Infection Control in the US. On December 18, 2015, in association with the exclusive distribution agreement signed with Getinge Infection Control on November 25, 2015, we received a purchase order from Getinge for the full amount of the minimum purchase commitment for 2016. Initial products associated with that order were partially assembled and not shipped until 2016, and consequently did not generate revenue or otherwise materially impact our results from operations in 2015.

### NET LOSS

In fiscal year 2015, net loss totaled $8.1 million or a loss of ($0.10) per share, as compared to $5.9 million or a loss of ($0.08) per share in 2014. During 2015, increased sales only partially offset additional incurred marketing expenses associated with the commercialization of our STERIZONE® VP4 Sterilizer, severance costs associated with a former executive, reduced R&D tax credits, and non recurrent expenses related to the write-off of patents and unrealized foreign exchange loss on deferred revenus in connexion with the Getinge Agreement.

| | 2015<br>$ | 2014<br>$ |
|---|---|---|
| **Net Loss, as reported** | **8,133,462** | 5,947,989 |
| **Adjustments** | | |
| Write-off of Patents | **(214,209)** | - |
| R&D Tax Credits Recognized | **145,186** | 570,485 |
| Severance to an executive member | **(394,139)** | - |
| Unrealized Foreign Exchange Loss on deferred revenues | **(365,250)** | - |
| **Adjusted Net Loss** | **7,305,050** | 6,518,474 |
| **Adjusted Net Loss per Share** | **0.09** | 0.09 |

The adjusted net loss in 2015 was $7.3 million ($0.09 per share), as compared to $6.5 million ($0.09 per share) in 2014. Our adjusted net loss in 2015 was higher because the Company incurred additional operating expenses as a result of the ramp-up of activities in the United States.

## EXPENSES

### Supply Chain

Supply Chain expenses include all expenses incurred in connection with production costs, related quality control and assurance expenses, cost of services sold to end-users, and shipping expenses.

For the fiscal year ended December 31, 2015, the Supply Chain expenses amounted to $2.1 million, as compared to $1,1 million for the same period in 2014. The variation is largely the result of higher operation costs in 2015 to support the STERIZONE® VP4 Sterilizer shipments in the United States.

### Marketing, Sales and Service

For the the fiscal year ended December 31, 2015, Marketing, Sales and Service expenses amounted to $0.9 million, as compared to $0.3 million for the same period in 2014. The larger amount in 2015 is due to an increase in (1) marketing-related activities, including trade shows and professional association meetings, (2) customer related travel expenses, and (3) salaries and commissions expenses in connection with the expansion in the United States.

### Research and Development

For the fiscal year ended December 31, 2015, Research and Development expenses were $2.8 million, as compared to $2.3 million in 2014. The year-to-year comparisons are impacted by the recognition of R&D tax credits in 2014. In 2015, $TSO_3$ concentrated its effort on its new STERIZONE VP4® Sterilizer while at the beginning of 2014, the Company recorded R&D tax credits following amended reports for years 2011 and 2012.

| | 2015<br>$ | 2014<br>$ |
|---|---|---|
| **R&D Expenses as reported** | **2,808,041** | 2,333,113 |
| **R&D Tax Credits** | **145,186** | 570,485 |
| **R&D Expenses Before Tax Credits** | **2,953,227** | 2,903,598 |

Before accounting for the tax credits, R&D expenses were $3.0 million in 2015, as compared to $2.9 million in 2014. We incurred similar salary, test and consulting expenses in association with FDA clearance and product development activities in both years.

### Administrative

For the fiscal year ended December 31, 2015, administrative expenses amounted to $4.2 million, as compared to $2.7 million for the same period in 2014. The variation is mainly the result of an increase in (1) investors relations activities (2) professionnal fees related to the incorporation of the subsidiary $TSO_3$ Corporation and the Getinge Agreement and (3) salary expenses including the severance amount of $394,139 due to an executive member.

## Financial Position Analysis

(Audited, IFRS Basis, CAD$)

| | **2015** | 2014 |
|---|---|---|
| **Cash, Cash Equivalents and Short-term Investments** | **20,915,182** | 5,973,446 |
| **Accounts Receivable** | **609,930** | 257,694 |
| **Inventories** | **1,802,423** | 1,293,503 |
| **Property, Plant and Equipment** | **503,541** | 557,515 |
| **Intangibles Assets** | **2,340,530** | 2,432,653 |
| **Accounts Payable and Accured Liabilities** | **1,822,136** | 676,058 |
| **Deferred Revenues (short and long term)** | **10,431,625** | 82,019 |
| **Equity** | **14,027,491** | 9,859,028 |

### Liquid Assets

As at December 31, 2015, cash, cash equivalents and short-term investments amounted to $20.9 million, as compared to $6.0 million as at December 31, 2014. During 2015 we received net proceeds of $10.3 million from the public equity offering closed on March 5, 2015, $1.3 million from warrants exercised and US$7.5 million associated with our exclusive distribution agreement with Getinge Infection Control, which we signed on November 25, 2015. These influxes of cash were offset by approximately $6.9 million in cash used to fund our operating expenses during the twelve-month period ended December 31, 2015.

As at February 5, 2016, 7.2 million warrants were exercised and the total proceeds equaled to $13.5 million leaving the Company with more than $32 millions in cash, cash equivalents, and short-term investments when including all proceeds from warrant exercises.

### Accounts Receivable

As at December 31, 2015, the accounts receivable amounted to $0.6 million, as compared to $0.3 million as at December 31, 2014, which in both cases are largely made up of amounts recoverable from governments for R&D tax ($0.2 million at the end of 2015 related to 2015 and 2014) and sales tax credits ($0.2 million at the end of 2015) which were higher at the end of 2015.

### Inventories

As at December 31, 2015, inventories amounted to $1.8 million, as compared to $1.3 million as at December 31, 2014.

| | **2015** **$** | 2014 $ |
|---|---|---|
| **Raw Materials** | **968,212** | 918,993 |
| **Work in Progress** | **378,173** | 310,166 |
| **Finished Goods** | **456,038** | 64,344 |
| | **1,802,423** | 1,293,503 |

We grew our inventories marginally in December 31, 2015 in order to build supply of parts for product to be delivered in 2016. Inventories include sterilizers produced to meet the demand of the following quarter.

**Property, Plant and Equipment**

The amount of Property, Plant and Equipment did not vary materially between December 31, 2014 and December 31, 2015 as the Company capitalized only $0.3 million in 2015 with a total depreciation amount of $0.3 million during the same period.

**Intangibles Assets**

For fiscal year 2015, the amount of intangible assets decreased from $2.4 million on December 31, 2014 to $2.3 million on December 31, 2015. The variation was due to the net write-off of $0.2 million in Q1 2015 in connection with abandoned patents while the acquisitions offset the amortization.

**Accounts Payable and Accrued Liabilities**

As at December 31, 2015, accounts payable and accrued liabilities amounted to $1.8 million, as compared to $0.7 million as at December 31, 2014. The increase is due to trade payables for an amount of $0.7 million almost exclusively related to inventories and in accrued liabilities for an amount of $0.2 million regarding the severance payable to an executive member.

**Deferred Revenues**

As at December 31, 2015, deferred revenues amounted to $10.4 million, as compared to $82,000 as at December 31, 2014. That increase is the $7.5 million in US currency received in 2015 in association with the exclusive distribution agreement with Getinge.

On November 25, 2015, the Company entered into an exclusive distribution agreement with Getinge to distribute the STERIZONE® VP4 Sterilizer worldwide in exchange for US$7.5 million. The agreement includes performance requirements that are multi-year as well as a formula for minimum unit shipments. Getinge will also receive ongoing technical support from $TSO_3$. Sales under the agreement are made on a fixed price basis in US dollars to Getinge, who will be the only customer for the STERIZONE® VP4 Sterilizer while the agreement is in force.

Deferred revenues represent the unamortized portion of prepaid service contracts covering a part of the installed base of STERIZONE® 125L+ Sterilizers in Canada as well as the unamortized part of the deferred license revenue received under the Getinge Agreement which is recognized as services are rendered and as products are delivered over the term of the agreement.

**Shareholders' Equity**

As at December 31, 2015, Shareholders' Equity amounted to $14.0 million, as compared to $9.9 million as at December 31, 2014. The variation is primarily the result of the net proceeds of $10.3 million from the equity issue closed by the Company on March 5, 2015, the net proceeds of $1.3 million from the warrants exercised and the absoption of the operating deficits incurred during the twelve-month period of 2015.

## Cash Flows Analysis

(Audited, IFRS Base)

| | **2015** | 2014 |
|---|---|---|
| | **$** | $ |
| Operating Activities | **3,882,450** | (3,790,704) |
| Investing Activities | **(3,956,708)** | 2,760,992 |
| Financing Activities | **11,614,831** | 365,750 |

**Operating Activities**

Cash generated by the operating activities amounted to $3.9 million for the fiscal year 2015, as compared to an consumption of $3.8 million in 2014. Cash consumption of $6.9 million resulting from our increased operating activities as we expanded our operation activities in support of commercialization of our STERIZONE® VP4 Sterilizer, was more than offset by the $10.4 million (US$7.5 million) in proceeds we received in the fourth quarter of 2015 upon signing our exclusive distribution agreement with Getinge Infection Control.

**Investing Activities**

For the fiscal year ended December 31, 2015, Investing Activities absorbed $4.0 million, as compared to a generation of $2.8 million in 2014, an increase resulting mainly of the acquisition of short-term investments. Excluding the purchase and redemption of short-term investments, cash used in investing activities was $0.6 million in 2015 half of which is related to patents.

**Financing Activities**

For the fiscal year ended December 31, 2015, $11.6 million were generated by Financing Activities due to the closing of an equity issue on March 5, 2015 and the warrants and options exercised.

## Summary of Quarterly Results

(Unaudited, IFRS Basis)

This table shows the quarterly evolution of sales, net loss and net loss per share.

| ($000 EXCEPT LOSS/SHARE) | | | | **2015** | | | | 2014 |
|---|---|---|---|---|---|---|---|---|
| | **Q4** | Q3 | Q2 | Q1 | Q4 | Q3 | Q2 | Q1 |
| Sales | **196** | 1,210 | 137 | 90 | 120 | 99 | 132 | 82 |
| Net Loss | **(2,885)** | (1,682) | (1,748) | (1,818) | (1,635) | (1,427) | (1,325) | (1,561) |
| Net Loss per Share (basic and diluted) | **(0.03)** | (0.02) | (0.02) | (0.02) | (0.02) | (0.02) | (0.02) | (0.02) |

# Fourth Quarter Analysis

(Unaudited, IFRS Basis, CAD$ except share figures)

Three-month period ended December 31, 2015, compared to the three-month period ended December 31, 2014:

| | Fourth Quarter 2015 | Fourth Quarter 2014 |
|---|---|---|
| **Sales** | **196,763** | 120,506 |
| **Expenses** | | |
| Supply Chain | **647,210** | 411,252 |
| Marketing, Sale and Service | **215,379** | 67,471 |
| Research and Development | **902,580** | 543,357 |
| Administrative | **1,410,534** | 751,320 |
| Financial | **(93,960)** | (17,271) |
| **Total Expenses** | **3,081,742** | 1,756,129 |
| **Net Loss before income Taxes** | **2,884,980** | 1,635,623 |
| **Income Taxes** | **-** | - |
| **Net Loss and Comprehensive Loss attributable to Shareholders** | **2,884,980** | 1,635,623 |
| Basic and Diluted Loss per Share | **0.03** | 0.02 |
| Weighted Average Number of Shares Outstanding | **83,274,046** | 73,378,113 |

### SALES

For the three-month period ended December 31, 2015, total revenues amounted to $0.2 million, as compared to $0.1 million for the same period in 2014. Sales of consumable supplies and accessories were higher in Q4 2015 than in Q4 2014. On December 18, 2015, in association with the exclusive distribution agreement signed with Getinge Infection Control on November 25, 2015, we received a purchase order from Getinge for the full amount of the minimum purchase commitment for 2016. Initial products associated with that order were partially assembled and not shipped until 2016, and consequently did not generate revenue or otherwise materially impact our results from operations in the fourth quarter of 2015.

### NET LOSS

For the three-month period ended December 31, 2015, the Company recorded a net loss of $2.9 million, or $0.03 per share, as compared to a net loss of $1.6 million, or $0.02 per share for the same period in 2014.

The higher loss in 2015 is reflecting the higher operation costs in 2015 to support the ramp-up related to the STERIZONE® VP4 Sterilizer in the United States, the increase in marketing efforts, the increase in professionnal fees related to the Getinge Agreement, the decrease in R&D tax credits and unrealized foreign exchange loss on licence deferred revenue.

### EXPENSES

#### Supply Chain

For the three-month period ended December 31, 2015, supply chain expenses amounted to $0.6 million, as compared to $0.4 million for the same period in 2014. The increase experienced in 2015 is mainly the result of additional salaries to support the ramp-up related to the STERIZONE® VP4 Sterilizer in the United States.

### Marketing, Sales and Service

For the three-month period ended December 31, 2015, marketing, sales and service expenses amounted to $0.2 million, as compared to $67,000 for the same period in 2014. The larger amount in 2015 is due to an increase in marketing-related activities and in salaries expenses in connection with the expansion in the United States.

### Research and Development

For the three-month period ended December 31, 2015, research and development expenses amounted to $0.9 million, as compared to expenses of $0.5 million for the same period in 2014. Before accounting for the tax credits, R&D expenses were $0.9 million in Q4 2015, as compared to $0.7 million in Q4 2014. The variation is the result of higher expenses related to FDA submissions in 2015.

### Administrative

For the three-month period ended December 31, 2015, administrative expenses amounted to $1.4 million, as compared to $0.8 million for the same period in 2014. The variation is mainly the result of travel, professional and communication fees related to investor relations and to the exclusive distribution agreement signed with Getinge in the fourth quarter of 2015.

## Cash Flows Analysis

(Unaudited, IFRS Basis)

| | Fourth Quarter | |
|---|---|---|
| | **2015** | 2014 |
| | **$** | $ |
| Operating Activities | **8,924,383** | (906,698) |
| Investing Activities | **(1,248,390)** | 1,415,528 |
| Financing Activities | **30,750** | 42,000 |

### Operating Activities

Cash generated by Operating Activities amounted to $8.9 million for the three-month period ended December 31, 2015, as compared to $0.9 million consumed for the same period in 2014. Fourth Quarter 2015 cash consumption of $2.5 million resulting from our increased operating activities as we expanded our operation activities in support of commercialization of our STERIZONE® VP4 Sterilizer, was more than offset by the $10.4 million (US$7.5 million) in proceeds we received in the fourth quarter of 2015 upon signing our exclusive distribution agreement with Getinge Infection Control.

### Investing Activities

For the three-month period ended December 31, 2015, cash flows absorbed by the Investing Activities amounted to $1.2 million while these activities generated an amount of $1.4 million for the same period in 2014. The variation experienced in Q4 2015 as compared to Q4 2014 was primarily the result of the acquisition of short-term investments in 2015 and their monetization in 2014.

### Financing Activities

For the three-month period ended December 31, 2015, cash flows generated by the Financing Activities amounted to $30,750 as compared to $42,000 for the same period in 2014.

## Segmented Information

The Company is structured as a single operating segment.

Substantially all property, plant and equipment of the Company are currently located in Canada.

Sales are allocated between geographic areas based on the location of the invoiced client and are as follows for periods ended December 31:

| | Fourth Quarter | | | | Twelve months | | | |
|---|---|---|---|---|---|---|---|---|
| | **2015** | | 2014 | | **2015** | | 2014 | |
| | **$** | **%** | $ | % | **$** | **%** | $ | % |
| Canada | **136,223** | **69** | 112,995 | 94 | **464,689** | **28** | 351,783 | 81 |
| United States | **60,540** | **31** | 7,511 | 6 | **1,168,555** | **72** | 81,204 | 19 |
| | **196,763** | **100** | 120,506 | 100 | **1,633,244** | **100** | 432,987 | 100 |

## Contractual Commitments

As at December 31, 2015, the contractual commitments for future fiscal years are as follows:

| | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|
| | $ | $ | $ | $ | $ |
| Operating leases and service contracts | 225,000 | 107,000 | 87,000 | 86,000 | 57,000 |

Operating leases are related to leases of premises with lease terms of one and five years. The Company does not have an option to purchase the leased premises at the expiry of the lease periods.

## Off-Balance Sheet Arrangement

Other than disclosed under the heading “Contractual Commitments” and purchase orders issued in the normal course of business, the Company made no off-balance sheet arrangement during the fourth quarter of 2015.

## Additional Disclosure – Unrecorded Tax Assets

The Company has accumulated a substantial amount of losses, unclaimed expenses and tax credits that could be claimed in the future to reduce income taxes. The related deferred income tax assets will be recorded on the Consolidated Financial Statements only when the Company concludes that these tax assets will probably be materialized by shielding profits from taxes, or otherwise. If the Company had reached this conclusion on December 31, 2015, an amount of $26,036,000 in tax assets would have been recorded based on an effective rate of 15% for federal taxes and 11.9% for provincial taxes. As at December 31, 2014, the net amount was $25,020,000.

## Capital Resources

The Company needs capital primarily to finance its sale and marketing activities, its production, its research and development, its supply chain, administrative and communication expenses, its working capital and its capital expenditures. The Company's capital is comprised of share capital, reserve for share-based compensation and reserve for warrants.

Depending on the quality of the credit structure of a prospective debt transaction and prevailing market conditions, the Company could finance a portion of its cash needs through debt issues. However, given its history of negative earnings, it is unlikely at the present time that the Company could access senior debt financing in any sizable amount from traditional sources such as commercial banks. In the past, the Company has financed its activities through public and private financings and, to a small extent, through government grants and tax credits.

In connection with its monitoring of the cash position of the Company, management uses a non-IFRS measure designated as the *"cash burn rate"* or *"burn rate".* Such measure is equal to the variation in liquid assets (cash, cash equivalents, and short-term investments) during a period excluding net cash proceeds from financings, licencing and R&D tax credit.

In Q4 2015, the average monthly burn rate was $0.6 million and $0.5 million in Q4 2014. For the twelve-month period ended December 31, the average monthly burn rate was $0.6 million in 2015, as compared to $0.5 million for the same period in 2014. The burn rate is higher in 2015 due to the ramp-up of activities which has started consuming cash at the beginning of 2015.

As at December 31, 2015, the Company had $20.9 million in cash, cash equivalents and short-term investments. Based on the average monthly burn rate of $0.6 million experienced in 2015. We believe we have sufficient funds to fund our operation through 2016. Subsequent to the year ended, $TSO_3$ received $13.5 million as a result of exercised warrants subject to accelerate expiry and $0.6 million related to compensation warrants.

The Company invests its funds in highly liquid short-term investments as required by its Investment Policy (see section on Risk Factors). These securities are chosen on the basis of foreseen cash requirements and safety.

As at December 31, 2015, the number of outstanding shares was 83,324,789.

## Use of Proceeds from the March 5, 2015 Public Offering

The following disclosure is made in compliance with paragraph (i) of Item 1.4 of Form 51-102F1 of National Instrument 51-102 of Canadian Securities Laws applicable to the Company which requires the Company to compare in tabular form previous public disclosure made about how the Company was to use proceeds (other than working capital) from any financing and to provide an explanation of variances and the impact of the variances, if any, on the Company's ability to achieve its business objectives and milestones

On February 25, 2015, the Company issued a prospectus in connection with a share and warrant issue closed on March 5, 2015 with net proceeds of $10,350,000. The following table compares (1) how the Company was then estimating to spend the net proceeds from the issue and (2) the actual use of these funds:

| | Use of funds as originally planned | Actual use of funds as at December 31, 2015 | Funds remaining to be used | Variance |
|---|---|---|---|---|
| Net proceeds from the issue, including the overallotment option | 10,445,000 | 10,350,265 | 8,199,281 | (94,735) |
| **Use of proceeds** | | | | |
| Initiate and Support commercialization efforts for STERIZONE® 125L+ and STERIZONE® VP4 Sterilizers: | | | | |
| Trade show and marketing collateral | 1,250,000 | 259,674 | 990,326 | - |
| Staffing | 1,750,000 | 380,703 | 1,369,297 | - |
| Support the ramp-up of production activities | 3,000,000 | 872,158 | 2,127,842 | - |
| Extend material compatibility studies | 1,000,000 | 184,741 | 815,259 | - |
| Advance development of STERIZONE® 80L | 1,000,000 | - | 1,000,000 | - |
| General corporate and administrative purposes | 2,445,000 | 548,443 | 1,896,557 | (94,735) |
| **Total Use of funds from March 5, 2015 until December 31, 2015** | 10,445,000 | 2,245,719 | 8,199,281 | (94,735) |

Almost ten months after the closing of the issue, most of the proceeds from the equity issue have not yet been used. As the funds are to be utilized to fund expenses that will occur over the next several months, no variance (other than the expenses from the issue) has yet materialized.

## Accounting Policies

The reader is refered to notes 2 and 3 of the Company's Annual Audited Consolidated Financial Statements for the year ended December 31, 2015 for a detailed presentation of accounting policies, critical accounting judgments, key source of estimation uncertainty and futures accounting changes.

## Risk Factors

The Company has identified certain risks and uncertainties that may have a material adverse effect on its business, results of operations, or financial condition. In any such case, the market price of its common shares could decline, and investors may lose all or part of their investment. Only potential investors who are experienced in high risk investments and who can afford to lose their entire investment should consider an investment in the Company.

The following list of risk factors is not exhaustive. Investors should carefully consider these and other risks, one or all of which may be material, before purchasing securities of the Company. The Company will, on occasion, make forward looking statements about its expectations, its business and industry, and operations. These forward looking statements are made at a point in time, based on certain assumptions. They are subject to change without notice as a result of the risks described herein and other risks. Investors or potential investors in the Company should not rely on forward-looking statements or the Company's historical operating performance as a prediction of actual results, and the Company undertakes no obligation to update forward looking information. In addition, the Company operates in a rapidly changing business, economic and regulated environment, and new potentially material risk factors emerge from time to time.

**Management of Growth**

2016 is a pivotal year for $TSO_3$, as the Company prepares to ramp its sales and production volumes to levels it has not experienced in its history. There are many challenges associated with such change, such as the ability to expand its production of quality products, the timing and quality of sales through a global distributor and into hospitals and other medical end customers, multinational sales and operations, the ability to source materials, subassemblies, accessories and consumables for its products, the ability for the limited suppliers and other third parties on which the Company is dependent to scale with the Company and provide the goods and services the Company needs, import and export regulations and taxes, ability to recruit and retain appropriate personnel, changes in regulatory environment, access to appropriate amounts of capital, and increased transportation and hazardous materials considerations. Some of these challenges are new to the Company and the third parties on whom we rely. Additionally, the Company's lack of history in volume sale of its products makes it more difficult for the Company to predict customer adoption and usage, sales cycles, incentive requirements, and competitive response, among other considerations. While the Company is aware of and addressing many of these challenges, there is no guarantee that the Company will successfully and smoothly address and forecast these and other challenges in the future. Failure to do so could result in a material adverse impact on expected and actual financial and operating results of the Company.

**Limited Revenue History and a History of Losses**

Since its inception in June 1998, $TSO_3$ has not yet generated significant revenues from the sale of its products. Until now, the Company has focused on developing new products, submitting and, in certain jurisdictions, obtaining marketing clearances and conducting limited commercial activities. Additional investments in research and development are required to continue the development and to support the application for clearance in the United States of new products based on the Company's's technology. It is unknown whether any of $TSO_3$'s future products will obtain the necessary clearances to be marketed in all major jurisdictions, including the United States.

Some of the products currently being developed may not be commercially available for some years to come or may be discontinued altogether, for reasons not within the control of the Company, and this may create difficulties or delays in operations or marketing efforts undertaken by $TSO_3$ as well as potential difficulties in achieving manufacturing and purchasing efficiencies.

Our success depends on our ability to design, manufacture and distribute new products. The Company operates in an area characterized by technological change and product innovation. Price is a key consideration in the client purchasing decisions. Our business performance is affected if our competitors become more effective and sell products at lower prices.

**Regulatory Approvals**

Sterilizers and other medical devices are subject to regulatory clearances within individual markets. As such, they are evaluated for compliance with established consensus standards. When a new technology is involved, in order to get US clearance through the 510(k) process, a manufacturer must identify an existing "predicate" device from which to compare the new technology. The Company has effectively demonstrated in the past that such "predicate" devices were equivalent with its first generation sterilizer and with its most recent technology, the STERIZONE® VP4 Sterilizer.

The Company has obtained clearance in Canada in December 2009 and in the European Community in March 2010 for its STERIZONE® 125L+ Sterilizer. While these are important markets and these clearances can be used in other countries, clearance in the US is the most important clearance to obtain and maintain due to the size of that market and its importance in terms of practice. The Company obtained clearance in the US for the STERIZONE® VP4 Sterilizer in December 2014, a market which size importance in terms of practice is unequaled in the rest of the world. Maintenance of these clearances is

critical for the Company, but as laws and regulation change, such maintenance may depend on parameters outside the Company's control.

The Company's business and financial condition could be adversely affected in the event that (1) a regulatory authority revokes any regulatory clearances granted in respect of the Company's products; (2) the Company fails to obtain regulatory clearance for modifications to existing products, for new products, or for the marketing of new uses for existing products of the Company; (3) regulatory authorities revise existing policies or regulations, or adopt additional regulations and the Company is unable to comply with such policies and regulations; or (4) the Company's products are subject to a recall.

Numerous statutes and regulations govern the manufacture and sale of sterilizers for medical use in Canada, the United States and other countries where the Company markets or intends to market its products. Such laws and regulations govern, among other things, the approval of manufacturing facilities, testing procedures and controlled research and the advertising of products. Failure to comply with statutes and regulations could result in warning letters, fines and other civil penalties, unanticipated expenditures, withdrawal of regulatory approval, delays in approving or refusing to approve modifications to existing products or new products, product recall or seizure, interruption of production, operating restrictions, injunctions or criminal sanctions.

The Company and its contract manufacturers and suppliers are also subject to numerous provincial and local laws relating to such matters as safe working conditions, manufacturing practices, environmental protection, fire hazard control and disposal of hazardous or potentially hazardous substances. The Company and its contract manufacturers and suppliers may be required to incur significant costs to comply with such laws and regulations in the future, and such laws and regulations may have an adverse effect on the Company's business. Failure of the Company or its contract manufacturers and suppliers to comply with current or changes in existing regulatory requirements could materially harm the Company's business. Furthermore, there can be no assurance that the Company's contract manufacturers and suppliers will continue to comply with regulatory requirements. In such circumstances, the Company's business or financial condition may be adversely affected.

**Healthcare Legislation**

The Company operates in a highly regulated industry and new laws, judicial decisions, or new interpretations of existing laws, or decisions, related to healthcare could negatively impact its business, operations and financial condition. Governments of local and foreign jurisdictions have in the past considered, are currently considering and may in the future consider, healthcare policies and proposals intended to curb rising healthcare costs. Future significant changes in the healthcare systems in Canada, Europe, the United States or elsewhere in the world, and current uncertainty about whether and how changes may be implemented, could have a negative impact on the demand for the products of the Company. It is not possible to predict whether other healthcare legislation or regulations affecting the Company's business may be proposed or enacted in the future; what effect any legislation or regulation would have on that business; or the effect ongoing uncertainty about these matters will have on the purchasing decisions by the Company's customers. Changes to regulations, standards and guidelines and the establishment of new regulatory authorities may affect the Company's existing or future regulatory clearances.

**Dependence on Commercialization Partners**

Worldwide distribution of the Company's products critically depends on its channel partners, and the conditions of distribution agreements with such channel partners. The Company announced in November 2015 the conclusion of a worldwide exclusive distribution agreement with Getinge Infection Control AB for the STERIZONE® VP4 Sterilizer and as such, the Company is highly dependent on Getinge's commitment and success at marketing and distributing the STERIZONE® VP4 Sterilizer.

To the extent that the Company relies on third parties, such as Getinge, to market and distribute its products, the commercial success of such products may be beyond the Company's control. There is no

assurance that any agreement with third parties will be beneficial to the Company and, while the agreement with Getinge provides for a fixed selling price of the STERIZONE® VP4 Sterilizer to Getinge, the Company may conclude that sales incentives or discounts beyond what is contemplated in the Getinge agreement may be in the best interests of the Company, which could materially impact our operating results. The inability of Getinge or any other commercialization partner of the Company to successfully commercialize and distribute the Company's products could have a material adverse effect on the Company's business, financial condition or results of operations. Given that the potential market for the Company's products is limited to users of the STERIZONE® VP4 Sterilizer, if our third-party commercialization partners are unable or unwilling to resell the STERIZONE® VP4 Sterilizer on a timely basis, the Company may not be able to achieve the level of sales of consummables projected by the Company. In addition, there is no assurance that the Company will be able to establish additional distribution agreements for its future products on favourable terms, if at all, or that such commercialization arrangements will be successful.

**Customer Concentration**

The Company has a very concentrated customer base, with Getinge as its exclusive client for the STERIZONE® VP4 Sterilization System pursuant to a worldwide exclusive distribution agreement announced by the Company in November 2015. The Company currently expects sales to Getinge to represent the vast majority of its total sales for the next several years. The termination of such agreement or a default by either party for any reason would have a material adverse effect on the business, financial condition or results of operations of the Company. In addition, a decline in sales volumes and/or price of products sold to Getinge could have a material adverse effect on the business, financial condition or results of operations of the Company.

Furthermore, since the Company's products are ultimately sold to hospitals and other healthcare providers, public budgetary constraints may significantly impact the ability of hospitals and other costumers supported by such systems to purchase our products. The purchasing and implementation volumes and timelines of such end customers are also typically hard to predict. The Company may experience significant fluctuations as a result of volatility of end customer demand for its sterilizers and the consumables associated with them. If government or other third-party payors implement measures to regulate pricing or contain costs or if our costs increase more rapidly than reimbursement level or permissible pricing increases or we do not satisfy the standards or requirements for reimbursement, our revenues or profitability may suffer and our business, performance, value, prospects, financial condition or results of operations may be adversely affected.

**Compatibility with Medical Instruments**

All sterilization processes can affect medical instruments or alter their key properties over a period of time. Taking into consideration the nature of the devices to be sterilized and the oxidative effects on devices in contact with hydrogen peroxide and ozone, $TSO_3$ seeks to expose instruments to a gentle cycle to reduce to a minimum the frequency and duration that the devices are exposed to hydrogen peroxide and ozone. Nevertheless, oxidation can produce several effects, depending on the material. In order to fully establish the true commercial value of its sterilization process, the Company must continue to demonstrate the compatibility of its technology with a wide range of medical instruments. Even though the tests and studies undertaken to date by $TSO_3$ have shown that its STERIZONE® Sterilization Process is compatible with the majority of medical instruments currently used in the hospital environment, the Company must maintain and extend ongoing studies in this respect.

**Intellectual Property and Technologies**

The Company's success depends, in part, on the Company's ability to obtain patents or rights thereto, protect trade secrets, and operate without violating the exclusive rights of third parties.

Although the Company already owns certain pending applications or issued patents, there is no guarantee that such patents are valid, that the pending applications will be allowed, or that the Company will develop other patentable technologies in the future. Moreover, there can be no assurance that a patent granted to the Company or in respect of which the Company holds a license will make the related product more competitive, that third parties will not contest the protection granted by the patent, or that the patents of third parties will not be detrimental to the Company's commercial activities.

In order to protect or enforce the intellectual property rights owned, used or commercialized by the Company, the Company may have to initiate legal proceedings against third parties. The Company may also have to defend claims brought against it or any purchaser or user of its products asserting that such product or process infringes intellectual property rights of third parties. Legal proceedings relating to intellectual property typically are expensive, take significant time and divert management's attention from other business matters. The cost of such litigation could adversely affect the business of the Company. Further, should the Company not prevail in an infringement lawsuit brought against it, the Company may have to pay substantial damages, and could be required to stop the infringing activity or obtain a license to use the patented technology. Such royalty or licensing agreements, if required, may not be available on acceptable terms, if at all. In the event a claim is successful against the Company and the Company cannot obtain a license to the relevant technology on acceptable terms, license a substitute technology or redesign potential products to avoid infringement, the business, financial condition and operating results of the Company could be materially adversely affected. Loss of patent protection could lead to new competition for the Company's current and future products, which could materially and adversely affect the financial prospects for the Company's products.

There is no guarantee that other companies will not independently develop products similar to those of the Company, that they will not imitate the Company's products, or that the Company's competitors will not develop products designed to circumvent the Company's exclusive proprietary rights. The Company may also need to obtain rights for other technologies belonging to third parties, but there is no guarantee that such technologies will be offered to the Company on acceptable terms. If the Company does not obtain such licenses, the commercialization of one or more of its products could be delayed. In addition, the Company could incur considerable costs to prosecute or defend proceedings in which the Company asserts its proprietary rights against third parties.

**Dependency on Key Personnel**

$TSO_3$ believes that its success will continue to depend on its ability to attract and retain qualified managers and other key personnel, in particular its executive officers and key management, scientific, technical and sales personnel. The loss of the services of the Company's key personnel could have a material adverse effect on the business and results of operations of the Company. The Company does not maintain key person life insurance policies on any of its officers or employees. The competition for qualified employees is intense. The investment required to attract and retain key personnel, including the provision of compensation packages that are competitive, could have an impact on the profitability of the business of the Company. Compensation and benefit packages provided by the Company may not be viewed as competitive and the Company may have to increase salaries and benefits in an effort to retain key employees; the failure to do so could adversely affect the Company's ability to attract or retain key employees.

**Expansion Risk**

The Company is regularly presented with and considers acquisitions of third party organizations, products or technologies in the ordinary course of its business. Consideration for such acquisitions could be in the form of any or a combination of cash, Company stock, assumed liabilities or other consideration. Such consideration may materially alter the liquidity position of the Company and/or dilute current shareholders. There can be no assurance that the Company will be able to identify, acquire or profitably manage additional businesses, or successfully integrate any acquired business, products, or technologies into the business without substantial expenses, delays or other operational or financial difficulties. There can be

no assurance that acquired businesses, products or technologies, if any, will achieve anticipated revenues and income.

**Competition Risks**

The Company's products face intense competition from competitors, such as Steris Corporation or Johnson & Johnson and others, that may have greater financial, market share, sales, marketing and other resources than $TSO_3$ and/or Getinge. $TSO_3$'s competitors and potential competitors may succeed in developing products and processes that are more effective and less expensive to use than any products or processes the Company may develop or license, or that may render $TSO_3$'s products or processes obsolete. Additionally, these competitors have the financial resources to compete on price, and could cause the Company to reduce the price at which it sells its products.

**Product Liability Issues**

In the health sector, lawsuits, often claiming substantial damages, are becoming increasingly common. In particular in the United States, lawsuits are filed by patients, employees or beneficiaries against healthcare providers, as well as authorities operating and managing hospitals in the private and public sectors. During these proceedings, claimants could allege and blame the non-sterility of certain instruments or defective functioning of products sold, installed or derived from $TSO_3$ technology. The Company maintains insurance to defend against such claims, but there is no assurance that such insurance provides sufficient limits or has the breadth to cover some or all such potential claims.

**Need for Additional Capital and Liquidity**

The Company may decide or need to raise funds in order to fund operations, improve its cash reserves, undertake strategic initiatives or acquisitions or for other corporate purposes. The Company anticipates that it will continue to have negative cash flow until such time, if at all, that profitable commercialization of its STERIZONE® 125L+ and STERIZONE® VP4 Sterilizers is achieved. Such funds may not be available in a timely manner, under commercially favourable terms or at all.

Future financings could represent significant dilution to current shareholders. If convertible securities are included in future financings, such convertible securities could be dilutive to shareholders, and the sale of the underlying shares may have a depressive effect on the future price of the common shares of the Company.

Failure to obtain additional funds on favourable terms or at all, whether from operations or additional debt or equity financings, could require the Company to delay or abandon some or all of its anticipated expenditures or to modify its business strategy and could have a material adverse effect on the Company, its business prospects, results from operations and financial condition, including on its ability to complete certain internal development and commercialization projects or complete its submissions with regulatory agencies.

**Challenging Global Political and Economic Conditions**

The general economic and business conditions around the world affect the Company's business prospects and the demand for its products in Canada, the United States, Europe and elsewhere in the world. Such conditions include short and long-term interest rates, inflation, fluctuations in securities prices and capital markets, exchange rates, debt crisis periodically affecting certain countries, volatility in the financial markets throughout the world, the tightening of liquidity in selected financial markets, and the strength of the regional and international economies.

All of these factors affect the business and economic conditions in a given geographic region and, consequently, affect the demand for the products developed or being developed by the Company. Currency rate movements in the United States and other countries where the Company seeks to market

or distribute its products may significantly impact the Company's business prospects and future earnings as a result of foreign currency conversion adjustments. The monetary policies of the Bank of Canada, the US Federal Reserve and the European monetary authorities as well as other interventionist measures in capital markets by public organizations are impacting economic conditions and therefore have consequences on the Company's business prospects.

The Company has no control over changes in inflation and interest rates, foreign currency exchange rates and controls or other economic factors affecting its business or the possibility of political unrest, legal and regulatory changes in jurisdictions in which the Company operates or intends to market its products.

Credit and liquidity problems may make it difficult for some businesses to access credit markets and obtain financing and may cause some businesses slowdowns and liquidity needs. Our exposure to bad debt losses could increase if customers are unable to pay for products previously ordered and delivered. Global economic conditions may have adverse effects on our business. Our global market is made of governmental entities or other entities that rely on government healthcare systems or government funding. If government funding for healthcare becomes limited, our customers may be unable to pay their obligations on a timely basis or to make payment in full and it may become necessary to increase reserves.

**International Activities**

The Company conducts sales and distribution operations on a worldwide basis and is subject to a variety of risks associated with doing business outside Canada. The Company has international operations, including operations in the United States. Based on that, $TSO_3$ is subject to a number of risks and complications associated with international operations including risks associated with foreign exchange rate fluctuations, collecting receivables through some foreign legal systems; tax laws that restrict the Company's ability to use tax credits, transfer pricing restrictions; general economic and political conditions in countries where the Company operates or where end users of the products are located and difficulties in enforcing intellectual property in some countries.

Our expansion into foreign countries exposes us to unfamiliar regulations and may expose us to new obstacles to growth. We plan to continue to grow both domestically and internationally. Foreign operations carry special risks. Our business in the countries in which we currently operate and those in which we may operate in the future could be limited or disrupted by:

- Exchange rate fluctuations;
- Government controls;
- Import and export license requirements;
- Political or economic instability;
- Trade restrictions;
- Changes in tariffs and taxes;
- Our unfamiliarity with local laws, regulations, practices, and customs;
- Restrictions on repatriating foreign profits back to Canada or movement of funds to other countries;
- Difficulties in staffing and managing international operations.

Foreign governments and agencies often establish permit and regulatory standards different from those in Canada. If we cannot obtain foreign regulatory approvals, or if we cannot obtain them when or on terms we expect, our growth and profitability from international operations could be limited. Fluctuations in currency exchange could have similar effects.

**Foreign Currency Exchange Rates**

The Company will derive a large portion of its revenues from international sales, with the vast majority of its sales expected to be in US dollars, while the Company's primary operating locations are in Canada,

and the Company incurs operating expenses in Canadian dollars. As a result, changes in foreign currency exchange rates could significantly affect the business, financial condition and results of operations of the Company.

The Company's exposure to foreign-exchange rate changes includes, but is not limited to the following:

- Certain long-term contracts with suppliers or customers may experience significant fluctuations in foreign exchange rates over several years thereby impacting cash flows and results of operations of the Company; and
- Certain contracts may involve foreign exchange risk when costs are incurred in a different currency than revenue.

**Suppliers**

If our suppliers are not able to make parts available or if there is an increase of cost of raw material, it might increase our production costs or limit our production capabilities. The availability and prices of raw materials are subject to volatility and are influenced by worldwide economic conditions, currency exchange rates, anticipated or perceived shortages, and other factors. Increases in prices or decreases in availability of raw materials might impact the Company procurement or increase its production costs. Unavailability or short supply of certains products may impact the business and its performance. These risks are exacerbated by our anticipated growth.

**Hazards and Risks**

The Company's operations, and those of its suppliers, are subject to a variety of business continuity hazards and risks. Business continuity hazards and other risks include, but is not limited to fires, earthquakes and flood; mechanical failures; unscheduled downtime; labor difficulties; delays in obtaining required licenses and inability to hire or retain key management or employees. The occurrence of any of these events might disrupt or shut down operations, or impact the production or profitability as a whole. Certain casualties also might cause personal injury, loss of life or severe damage to property and equipment, and result in liability claims against the Company. Even if the Company maintains property and casualty insurance in the amounts that the Company believes are customary for its industries, the Company insurance coverages have limits and may not fully insured against all potential hazards and risks incident.

**Financial Instruments**

The Company's risk exposure includes the risk incurred in connection with its investments in financial instruments, namely cash, cash equivalents and short-term investments. In order to manage the risk entailed by these financial instruments, controls have been implemented and, in particular, an investment policy was adopted and implemented. The Company considers that the return on short-term investments is secondary to risk minimization and primarily aims to optimize cash flows from a maturity perspective. With respect to investments, the main risk exposures are as follows:

*Market Risk*

Market risk is the risk that the value of a financial instrument will fluctuate as a result of changes in the parameters underlying its measurement, particularly interest rates and exchange rates.

*Interest Rate Risk*

Interest rate risk exists when interest rate fluctuations modify the cash flows of the Company's investments, including the price at which an investment could be sold.

As December 31, 2015, if interest rates on that date had been 0.5% lower, and all other variables held constant, the consolidated net loss and comprehensive loss for the period would have been $23,873 lower (no impact for the year ended December 31, 2014), arising mainly as a result of an increase in the fair value of fixed rate financial assets classified at fair value through profit or loss. If the interest rates on that date had been 0.5% higher, all other variables being held constant, the consolidated net loss and comprehensive loss for the period would have been $23,669 higher (no impact for the year ended December 31, 2014), arising mainly as a result of a decrease in the fair value of fixed rate financial assets classified at fair value through profit or loss. The net loss and comprehensive loss therefore have substantially the same sensitivity to interest rate increases and interest rate decreases.

*Credit Risk*

The use of financial instruments can create a credit risk entailing a risk of financial loss resulting from counterparty's inability or refusal to fully meet its contractual obligations. The Company's maximum exposure to credit risk is equal to the amounts recognized as receivables from clients, cash and cash equivalents and short-term investments.

Receivables from clients are from the sales and service provider and government-funded hospitals. By their size and their nature, the credit risk related to those receivables is reduced.

The Investment Policy established by the Company addresses management of credit risk exposures and permits investments in securities or instruments issued by, or guaranteed by, the Canadian federal or provincial governments, crown corporations as well as certain municipalities and financial institutions, provided that the issuer or guarantor benefits from a credit rating not less than A- on the rating scale of Standard and Poor's or the equivalent for other credit rating agencies. This policy sets limits to the size of exposures.

As at December 31, 2015 and 2014, the Company's short-term investments were rated by at least two recognized agencies and were within the credit ratings required by the Company's investment policy.

*Concentration Risk*

Concentration risk exists when investments are made with multiple entities that share similar characteristics or when a large investment is made with a single entity.

As at December 31, 2015 and 2014, there was no single investment that exceeded the limit required under the Company's Investment Policy.

*Liquidity Risk*

Liquidity risk represents the possibility that the Company may not be able to monetize its financial instruments so as to meet its financial commitments at the appropriate time and under reasonable conditions.

The Company's maximum exposure to liquidity risk is equal to the amounts recognized as accounts payable and accrued liabilities and these amounts will be paid in the following year. The Company manages this risk by maintaining sufficient liquidity available on demand to meet current and future financial obligations.

*Currency Risk*

The risk related to the exchange rate on financial instruments exists when monetary assets or liabilities are denominated in foreign currencies.

As at December 31, 2015, if the Canadian dollar had weakened 10 percent against the US dollar with all other variables held constant, the net loss and comprehensive loss for the period ended December 31, 2015 would have been $95,809 lower ($5,954 for the year ended December 31, 2014). Conversely, if the Canadian dollar had strengthened 10 percent against the US dollar with all other variables held constant, the net loss and comprehensive loss for the period ended December 31, 2015 would have been $95,809 higher ($5,954 for the year ended December 31, 2014).

*Fair Value*

The fair value of a financial instrument is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

The fair value of cash, cash equivalent, short-term investments, accounts receivable and accounts payable and accrued liabilities approximates their carrying values due to the short-term maturities of these items.

*Loss of Entire Investment*

An investment in the shares of the Company is highly speculative and may result in the loss of an investor's entire investment. Only potential investors who are experienced in high risk investments and who can afford to lose their entire investment should consider an investment in the Company.

*Volatility of Share Price*

Market prices for securities in general tend to fluctuate. In addition to general securities market conditions, factors such as the announcement (to the public, at science conferences or otherwise) of scientific or technologic innovations, new products, patents, the obtaining of exclusive rights by the Company or other companies, a change in regulations, publications, quarterly financial results, public concerns, future sales of common shares by the Company or current shareholders, the realization of any of the risks described herein and many other factors could have considerable repercussions on the price of the Company's common shares.

**Dividends**

Until now, the Company has never paid any cash dividend on its common shares and it currently intends to retain its future earnings, if any, to fund the development growth of its business. In addition, the terms of any future debt or credit facility may prevent the Company from paying any dividend unless certain consents are obtained and/or certain conditions are met.

**Other Risk Factors**

Additional risks not currently known to the Company or that the Company currently deems immaterial may also impair the Company's operations.

## Disclosure and Internal Controls

In accordance with National Instrument 52-109 of the Canadian Securities Authorities, the Company has filed certificates signed by the Chief Executive Officer ("CEO") and the Chief Financial Officer ("CFO") that, among other things, report on the design of disclosure controls and procedures (DC&P) and the design of internal control over financial reporting (ICFR).

The CEO and the CFO have designed DC&P, or caused them to be designed under their supervision, to provide reasonable assurance that (1) material information relating to the Company has been made

known to them and that (2) information required to be disclosed in the Company's filings is recorded, processed, summarized and reported within the prescribed time periods under securities legislation.

Also, the CEO and the CFO have designed ICFR, or have caused it to be designed under their supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of Financial Statements for financial reporting purposes in accordance with IFRS.

**Evaluation of Disclosure controls and procedures and internal controls over financial reporting**

An evaluation of the design of DC&P and ICFR is carried out annually under the supervision of the CEO and the CFO and the results of the last such evaluation were communicated to the Board of Directors as part of the review made in connection with the end of fiscal year 2015. This evaluation consisted of a review of documentation, audits and other procedures that management considered appropriate in the circumstances.

Based on this evaluation and using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) on Internal Control – Integrated Framework and in connection with the preparation of its financial report and management's discussion and analysis, the two certifying officers consider the design of DC&P and ICFR to be adequate for the Company's reporting for the year ended December 31, 2015.

**Changes in internal controls over financial reporting**

No changes were made to the Company's internal controls over financial reporting that occurred during the quarter and fiscal year ended December 31, 2015 that have materially affected, or are reasonably likely to materially affect, the internal controls over financial reporting.

# Management Report

**Responsibility of the Financial Statements**

The consolidated financial statements of $TSO_3$ Inc., which have been approved by the Board of Directors, were prepared by Management in accordance with International Financial Reporting Standards. It contains certain amounts based on best judgment and estimates as their final determination is dependent upon subsequent events. It is the opinion of Management that the accounting policies utilized are appropriate in the circumstances and are adequate to reflect the financial position and the financial performance within reasonable limits of materiality. The financial information presented elsewhere in this annual report is consistent with the information contained in the consolidated financial statements.

In order to carry out its responsibilities with regard to the consolidated financial statements, Management maintains internal control systems that aim to provide a reasonable degree of certainty that transactions are duly authorized, that the assets are well protected, and that adequate records are kept.

The Board of Directors' Audit and Risk Management Committee, comprised solely of board members who are neither executives nor employees of the Company, ensures that Management assumes its responsibility in terms of consolidated financial statements.

The functions of the Audit and Risk Management Committee are to:

- Review the consolidated financial statements and recommend them for approval by the Board of Directors;
- Review the systems of internal control and security;
- Recommend the appointment of the independent auditor and its fee arrangements to the Board of Directors;
- Review other accounting, financial and security matters as required.

This committee meets regularly with Management and the independent auditor. The latter may, as it see fit, meet with the Audit and Risk Management Committee, with or without Management, to discuss matters affecting the audit and financial information.

The independent auditor is appointed to report to the shareholders regarding the fairness of presentation of the Company's consolidated financial statements. The independent auditor fulfills its responsibility by carrying out an independent audit of these consolidated financial statements in accordance with Canadian generally accepted auditing standards.

The Management, Discussion and Analysis has been prepared as at March 22, 2016. Additional information on the Company is available through regular filing of press releases, annual reports, quarterly financial statements and the Annual Information Form on the SEDAR website www.sedar.com

On behalf of Management,

Richard M. Rumble
President and CEO

Glen Kayll
Chief Financial Officer

March 22, 2016

# Consolidated Financial Statements

*December 31, 2015 and 2014*

# Independent Auditor's Report

Deloitte LLP
925, Grande Allée Ouest,
suite 400
Québec QC G1S 4Z4
Canada

Tel.: 418-624-3333
Fax: 418-624-0414
www.deloitte.ca

To the shareholders of $TSO_3$ Inc.

We have audited the accompanying consolidated financial statements of $TSO_3$ Inc., which comprise the consolidated statements of financial position as at December 31, 2015 and 2014 and the consolidated statements of loss and comprehensive loss, the consolidated statements of changes in equity and the consolidated statements of cash flows for the years then ended and a summary of significant accounting policies and other explanatory information.

Management's responsibility for the consolidated financial statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. 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 consolidated financial statements.

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

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of $TSO_3$ Inc. as at December 31, 2015 and 2014, and its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards.

/s/Deloitte LLP [1]
March 22, 2016

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[1] CPA auditor, CA, public accountancy permit No. A107622

## Consolidated Statements of Loss and Comprehensive Loss

Years ended December 31, 2015 and 2014 (in Canadian $)

| | NOTES | 2015 $ | 2014 $ |
|---|---|---|---|
| **Sales** | 20 | **1,633,244** | 432,987 |
| **Expenses** | 5 | | |
| Supply Chain | | **2,056,571** | 1,118,498 |
| Marketing, Sales and Service | | **851,034** | 301,763 |
| Research and Development | | **2,808,041** | 2,333,113 |
| Administrative | | **4,228,403** | 2,720,249 |
| Financial | 4 | **(177,343)** | (92,647) |
| **Total Expenses** | | **9,766,706** | 6,380,976 |
| **Net Loss before Income Taxes** | | **(8,133,462)** | (5,947,989) |
| **Income Taxes** | | **-** | - |
| **Net Loss and comprehensive loss** | | **(8,133,462)** | (5,947,989) |
| **Basic and Diluted Net Loss per Share** | 21 | **(0.10)** | (0.08) |

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

## Consolidated Statements of Changes in Equity

(in Canadian $)

| | Notes | Share Capital $ | Reserve-Share-Based Compen-sation $ | Reserve – warrants $ | Deficit $ | Total $ |
|---|---|---|---|---|---|---|
| **Balance at January 1, 2014** | | 104,028,949 | 3,967,687 | 77,000 | (92,804,014) | 15,269,622 |
| Share-Based Compensation | 13 | - | 171,645 | - | - | 171,645 |
| Options exercised | 12 | 75,525 | (33,525) | - | - | 42,000 |
| Warrants exercised | 12, 14 | 394,975 | - | (71,225) | - | 323,750 |
| Transfer to Deficit – Warrants Expired | 14 | - | - | (5,775) | 5,775 | - |
| Net Loss for the Year | | - | - | - | (5,947,989) | (5,947,989) |
| **Balance at December 31, 2014** | | 104,499,449 | 4,105,807 | - | (98,746,228) | 9,859,028 |
| **Balance at January 1, 2015** | | 104,499,449 | 4,105,807 | - | (98,746,228) | 9,859,028 |
| Issuance of Share Capital and Warrants | 12, 14 | 10,883,600 | - | 616,400 | - | 11,500,000 |
| Options Exercised | 12 | 85,772 | (32,456) | - | - | 53,316 |
| Warrants Exercised | 12, 14 | 1,321,424 | - | (41,174) | - | 1,280,250 |
| Share-Based Compensation | 13 | - | 618,094 | - | - | 618,094 |
| Warrants Issued to Underwriters | 12, 14 | (108,100) | - | 108,100 | - | - |
| Share Issue and Warrants Issue Expenses | 12 | (1,088,109) | - | (61,626) | - | (1,149,735) |
| Net Loss for the year | | - | - | - | (8,133,462) | (8,133,462) |
| **Balance at December 31, 2015** | | 115,594,036 | 4,691,445 | 621,700 | (106,879,690) | 14,027,491 |

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

# Consolidated Statements of Financial Position

As of December 31, 2015 and 2014 (in Canadian $)

| | Notes | 2015 $ | 2014 $ |
|---|---|---|---|
| **Current Assets** | | | |
| Cash and Cash Equivalents | 6 | **17,514,019** | 5,973,446 |
| Short-term Investments | 6 | **3,401,163** | - |
| Accounts Receivable | 7 | **609,930** | 257,694 |
| Inventories | 8 | **1,802,423** | 1,293,503 |
| Prepaid Expenses | | **109,646** | 102,294 |
| | | **23,437,181** | 7,626,937 |
| **Non-current Assets** | | | |
| Property, Plant and Equipment | 9 | **503,541** | 557,515 |
| Intangible Assets | 10 | **2,340,530** | 2,432,653 |
| | | **2,844,071** | 2,990,168 |
| | | **26,281,252** | 10,617,105 |
| **Current Liabilities** | | | |
| Accounts Payable and Accrued Liabilities | | **1,822,136** | 676,058 |
| Deferred Revenues | 11 | **1,109,149** | 82,019 |
| | | **2,931,285** | 758,077 |
| **Non-current Liabilities** | | | |
| Deferred Revenues | 11 | **9,322,476** | - |
| | | **12,253,761** | 758,077 |
| **Equity** | | | |
| Share Capital | 12 | **115,594,036** | 104,499,449 |
| Reserve – Share-based Compensation | 13 | **4,691,445** | 4,105,807 |
| Reserve – Warrants | 14 | **621,700** | - |
| Accumulated Deficit | | **(106,879,690)** | (98,746,228) |
| | | **14,027,491** | 9,859,028 |
| | | **26,281,252** | 10,617,105 |

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

**Approved by the Board**

**Director**

**Director**

## Consolidated Statements of Cash Flows

Years ended December 31, 2015 and 2014 (in Canadian $)

| | NOTES | 2015 $ | 2014 $ |
|---|---|---|---|
| **Cash Flows from Operating Activities** | | | |
| Net Loss before Income Taxes | | **(8,133,462)** | (5,947,989) |
| Adjustments for: | | | |
| Depreciation of Property, Plant and Equipment | 9 | **306,906** | 422,192 |
| Amortization of Intangible Assets | 10 | **214,199** | 240,521 |
| Write-off of Property, Plant and Equipment | 9 | **-** | 91,888 |
| Write-off of Intangible Assets | 10 | **214,209** | 160,227 |
| Share-Based Compensation | 13 | **618,094** | 171,645 |
| Financial Income | 4 | **(128,081)** | (113,488) |
| | | **(6,908,135)** | (4,975,004) |
| Changes in Non-Cash Operating Working Capital Items | 16 | **10,663,667** | 1,061,487 |
| Interest Received | | **126,918** | 122,813 |
| **Cash Flows Generated by (Used in) Operating Activities** | | **3,882,450** | (3,790,704) |
| **Cash Flows from Investing Activities** | | | |
| Acquisition of Short-term Investments | | **(9,200,000)** | (4,503,044) |
| Disposal of Short-term Investments | | **5,800,000** | 7,464,842 |
| Acquisition of Property, Plant and Equipment | 9, 16 | **(220,423)** | (23,496) |
| Acquisition of Intangible Assets | 10 | **(336,285)** | (177,310) |
| **Cash Flows Generated by (Used in) Investing Activities** | | **(3,956,708)** | 2,760,992 |
| **Cash Flows from Financing Activities** | | | |
| Issuance of Share Capital and Warrants | 12 | **11,500,000** | - |
| Payment for Share Capital and Warrants Issue Expenses | 12 | **(1,149,735)** | - |
| Options Exercised | 12 | **53,316** | 42,000 |
| Warrants Exercised | 12, 14 | **1,211,250** | 323,750 |
| **Cash Flows Generated by Financing Activities** | | **11,614,831** | 365,750 |
| **Increase (Decrease) in Cash and Cash Equivalents** | | **11,540,573** | (663,962) |
| **Cash and Cash Equivalents at the Beginning** | | **5,973,446** | 6,637,408 |
| **Cash and Cash Equivalents at the End** | | **17,514,019** | 5,973,446 |

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

# Notes to the Consolidated Financial Statements

Years ended December 31, 2015 and 2014 (In Canadian $)

## 1. Description of Business

$TSO_3$ ("the Company") exists under the Business Corporations Act (Québec). Its activities encompass the sale, production, maintenance, research, development and licensing of sterilization processes, related consumable supplies and accessories for heat-sensitive medical devices. The Company designs products for sterile processing areas in the hospital environment that offer an advantageous replacement solution to other low temperature sterilization processes currently used. It also provides services related to the maintenance of sterilization equipment and compatibility testing of medical devices with such processes. The head office of the Company is located at 2505, avenue Dalton, Québec (Québec), Canada and its subsidiary office is located at 1636 American Way, Myrtle Beach, SC, United States.

## 2. Accounting Policies

### Statement of Compliance

The consolidated financial statements (the "financial statements") have been prepared in accordance with International Financial Reporting Standards (IFRS), included in the CPA Canada Handbook.

### Basis of Presentation

The financial statements have been prepared on a going concern basis, at historical cost, except for certain financial instruments that are measured at fair value, as explained in the accounting policies below. Historical cost generally reflects the fair value of the consideration given in exchange for assets.

The principal accounting policies are set out hereafter.

### Presentation Currency and Foreign Currency Translation

The financial statements are presented in Canadian dollars, the functional currency of the Company. The functional currency of the wholly-owned subsidiary located in the United States is the US dollars.

Foreign currency transactions of the Company are translated into Canadian dollars as follows: monetary assets and liabilities are translated at the exchange rates in effect at the reporting date, non-monetary assets and liabilities are translated at historical rates, revenues and expenses are translated at the exchange rates in effect at the time of the transaction, and exchange gains or losses resulting from translation are recorded in net income.

The wholly-owned subsidiary transactions are translated into Canadian dollars as follows: the assets and liabilities are translated at the exchange rates in effect at the reporting date, revenues and expenses are translated at the exchange rates in effect at the time of the transaction, and exchange differences are recorded in other comprehensive income and cumulated in a separate component of equity.

### Scope of Consolidation

The financial statements include the accounts of the Company and $TSO_3$ Corporation, its wholly-owned subsidiary. $TSO_3$ Corporation was created during the second quarter of 2015. Intercompany transactions, balances and unrealized gains or losses on transactions between group companies are eliminated.

# Notes to the Consolidated Financial Statements

Years ended December 31, 2015 and 2014 (In Canadian $)

## 2. Accounting Policies (cont'd)

### Scope of Consolidation (cont'd)

A subsidiary is an entity over which the Company has control. Control exists when the Company has of the following elements: (1) the power over the activities of the subsidiary, (2) the exposure or rights to variable returns from its involvement with the subsidiary and (3) the ability to use its power over the subsidiary to affect the amount of the Company's returns. A subsidiary is fully consolidated from the date on which control is transferred to the Company. They are deconsolidated from the date that control ceases.

### Revenue Recognition

Sales

The Company generates revenue from the sale of sterilizers, related spare parts and maintenance services, consumable supplies, accessories and compatibility testing services. The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the price to the buyer is fixed or determinable and collection is reasonably assured. In addition, the Company earns revenue from service contracts that is recognized using the straight-line method over the term of each contract.

Revenue from bill-and-hold arrangements is recognized when it is probable that delivery will be made, the item is clearly identified and ready for delivery, the buyer specifically acknowledges the deferred delivery instructions and usual payment terms apply.

License Revenue

The Company also generates license revenue resulting from an exclusive distribution agreement with Getinge Infection Control. These revenues are recognized as services are rendered and products are delivered over the term of the agreement (see Note 11).

Financial Income

Financial Income from a financial asset is recognized when it is probable that the economic benefits will flow to the Company and the amount of income can be measured reliably. Financial income is accounted for on an accrual basis, by reference to the principal outstanding and at the effective interest rate applicable, which is the rate that discounts estimated future cash receipts through the expected life of the financial asset to that asset's net carrying amount on initial recognition.

### Share-Based Compensation

The Company uses the fair value method to measure compensation expense at the date of award of stock options to employees. Fair value is determined using the Black-Scholes option pricing model and is amortized to net income over the vesting period with an offset to the Reserve - Share-Based Compensation. The amortization of the fair value is based on a graded vesting approach over the vesting period, and takes into consideration the number of options which are expected to vest. The forfeiture rate is revised regularly and changes are recorded to net income. When options are exercised, the corresponding amount in the Reserve - Share-Based Compensation and the proceeds received by the Company are credited to share capital. The Stock option plan is an equity-settled plan.

# Notes to the Consolidated Financial Statements

Years ended December 31, 2015 and 2014 (In Canadian $)

## 2. Accounting Policies (cont'd)

### Income Taxes

The Company follows the liability method of accounting for income taxes. Under this method, deferred income taxes are recognized based on the expected future tax consequences of differences between the carrying amount of consolidated financial position items and their corresponding tax basis, using the enacted and substantively enacted income tax rates for the years in which the differences are expected to reverse. Deferred income tax assets are recognized in net income only if their materialization is considered probable.

### Government Assistance and Research and Development Tax Credits

The Company incurs research and development expenses that are eligible for tax credits. The recorded tax credits are based on management's estimates of amounts expected to be recovered and are subject to audit by tax authorities. Government assistance, including the tax credits for scientific research and experimental development costs, is presented as a reduction of the related expense.

### Inventories

The cost of inventories is primarily determined using the first-in, first-out method. The specific identification of the individual cost is also used for inventories segregated for specific projects. In both cases, the cost of work in progress and finished goods includes the cost of raw materials and an applicable share of the cost of labor and manufacturing overhead based on normal production rates. Inventories are valued at the lower of cost and net realizable value.

A new assessment of net realizable value is performed each subsequent period. When the circumstances that justified writing down the inventories below cost no longer exist, or when there is a clear indication of an increase in net realizable value due to a change in the economic situation, the amount of the write-down is reversed and the new carrying amount is the lower of the cost or the revised net realizable value.

### Property, Plant and Equipment

Property, plant and equipment are recorded initially and subsequently at cost less depreciation and impairment. Depreciation is calculated using the straight-line method over the following estimated useful lives taking into account any residual value:

| | |
|---|---|
| Office Furniture and Lift Truck | 10 years |
| Equipment and Tools | 7 years |
| Sterilizers Used Internally | 5 years |
| Marketing Stand and Demonstration Equipment | 5 years |
| Medical Devices | 3 years |
| Computer Equipment | 3 years |
| Leasehold Improvements | 2 years |

The residual value, depreciation method and the useful life of an asset are reviewed at the end of each fiscal year.

# Notes to the Consolidated Financial Statements

Years ended December 31, 2015 and 2014 (In Canadian $)

## 2. Accounting Policies (cont'd)

### Intangible Assets

Intangible assets are recorded initially and subsequently at cost less amortization and impairment. Amortization is calculated using the straight-line method over the following estimated useful lives taking into account any residual value:

| | |
|---|---|
| *Acquired in a Business Combination* | |
| Technology | 20 years |
| *Acquired Externally* | |
| Patents | 20 years |
| Licenses | 9 years |
| Software | 3 years |
| Trademarks | 10 and 15 years |
| Web Site | 3 years |

The residual value, amortization method and the useful life of an asset are reviewed at the end of each fiscal year.

### Impairment of Property, Plant and Equipment and Intangible Assets

At the end of each reporting period, assets are reviewed for indication of any impairment. When such indicators are identified, the Company is required to perform an impairment test in order to measure the asset's recoverable value and to establish the amount of the impairment loss, if any. If it is not possible to determine the recoverable value for an individual asset, then the recoverable value is determined for the cash generating unit holding the asset.

The recoverable value is the higher of (1) an asset fair value less the cost to sell it and (2) its value in use. Value in use is the present value of estimated future cash flows discounted using a discount rate that reflects current market assessments of the time value of money and the risks specific to the asset for which estimated future cash flows were not adjusted.

If the asset's (or a cash generating unit's) estimated recoverable value is lower than its carrying value, the asset (or the cash generating unit's) carrying value is reduced to its recoverable value. An impairment loss is immediately recognized in the Consolidated Statements of Loss and Comprehensive Loss.

Where an impairment loss subsequently reverses, the carrying value of the asset is increased to the revised estimate of its recoverable value, but such reversal may not increase the carrying value in excess of the carrying value that would have been determined had no impairment loss been recognized for the asset in prior years. A reversal of an impairment loss is recognized immediately in the Consolidated Statements of Loss and Comprehensive Loss.

During the year ended December 31, 2015, further to its decision taken in 2014 to stop supporting its first generation sterilizers using only ozone as a sterilant, the Company performed an impairment test on all assets related to that technology. This led the Company to write-off certain patents that were related to the discontinued product. Finally, the Company reviewed its parts inventory and wrote-off parts, other than critical parts, that were discontinued or slow-moving.

# Notes to the Consolidated Financial Statements

Years ended December 31, 2015 and 2014 (In Canadian $)

## 2. Accounting Policies (cont'd)

### Warranty Provision

The Company offers a standard 12-month warranty on goods sold to its clients. The estimated cost of the warranty is based on the Company's history with defective sterilization devices and their related spare parts and accessories, the probability that these defects will materialize and their repair costs.

### Warrants

The Company uses the fair value method to measure the value of warrants at the award date. Fair value is determined using the Black-Scholes option pricing model and is recorded as part of the Reserve - Warrants. When warrants are exercised, the corresponding amount in the Reserve - Warrants and the proceeds received by the Company are credited to Share Capital.

### Financial Instruments

Financial assets and financial liabilities are recognized when the Company becomes a party to the contractual provisions of the instrument.

Financial assets and financial liabilities are initially recognized at fair value and subsequent measurement depends on how they are classified, which is described below. Their classification depends on the purpose for which the financial instruments were acquired or issued, their characteristics, and the designation made by the Company. Settlement date accounting is used.

Classification, Recognition and Measurement of Financial Instruments

Financial instruments are classified in categories and their measurement in subsequent periods depends on their classification. The Company has classified its financial instruments as follows:

| Category | Classification |
|---|---|
| Cash | Loans and Receivables |
| Cash Equivalents | Fair value through profit or loss |
| Short-term Investments | Fair value through profit or loss |
| Accounts Receivable | Loans and Receivables |
| Accounts Payable and Accrued Liabilities | Other Liabilities |

*Cash and Cash Equivalents*

Cash and cash equivalents include cash and investments with maturities of three months or less from the date of acquisition. These investments are highly liquid and are held for the purpose of meeting short-term cash commitments. Cash is recorded at amortized cost and cash equivalents are recorded at fair value.

*Short-term Investments*

Short-term investments are instruments presented at fair value through profit or loss because they will be used for short-term cash commitments. These investments are recorded at fair value. Increases and decreases in fair value are recognized as investment income.

# Notes to the Consolidated Financial Statements

Years ended December 31, 2015 and 2014 (In Canadian $)

**2. Accounting Policies (cont'd)**

**Financial Instruments (cont'd)**

*Accounts Receivable*

Accounts receivable are accounted for at amortized cost using the effective interest method.

*Accounts payable and Accrued Liabilities*

Accounts payable and accrued liabilities are accounted for at amortized cost using the effective interest method.

Transaction Costs

Transaction costs related to financial assets presented at fair value are expensed as incurred. Transaction costs related to other liabilities and to loans and receivables are added to the carrying value of the asset or are netted against the carrying value of the liability and are then recognized over the expected life of the instrument using the effective interest method.

Fair Value

The fair value of a financial instrument is defined as the price that would be received to sell an asset or pay to transfer a liability in an orderly transaction between market participants at the measurement date.

The fair value of cash, accounts receivable and accounts payable and accrued liabilities approximates their carrying values due to the short-term maturities of these items.

Impairment of financial assets

Financial assets, other than those at fair value through profit or loss, are assessed for indicators of impairment at the end of each reporting period. For the Company these elements are represented by cash and receivables. Financial assets are considered to be impaired when there is objective evidence that, as a result of one or more events that occurred after the initial recognition of the financial assets, the estimated future cash flows of the investments have been affected. As at December 31, 2015 and December 31, 2014, such event has not occurred and consequently no impairment loss has been taken.

**Critical Accounting Judgments and Key Sources of Estimates Uncertainty**

In the application of the Company's accounting policies, which are described in this note, management is required to make judgments, estimates and assumptions about the carrying amounts of assets and liabilities that are not readily apparent from other sources. The estimates and associated assumptions are based on historical experience and other factors that are considered to be relevant. Actual results may differ from these estimates. The following are the critical judgments and key sources of estimates:

# Notes to the Consolidated Financial Statements

Years ended December 31, 2015 and 2014 (In Canadian $)

**2. Accounting Policies (cont'd)**

**Critical Accounting Judgments and Key Sources of Estimates Uncertainty (cont'd)**

1. *Recoverability of Long-Lived Assets:*

   On an annual basis, the Company evaluates if there are indicators of impairment. When such indicators are identified, the Company is required to perform an impairment test in order to measure the recoverable amount of its long-lived assets. The main judgments made by management for the impairment test performed as at December 31, 2015 were the following:

   - Most probable discounted cash flow projections based on management's best estimate of the range of economic conditions that will exist over the remaining useful life of the intangible assets and property, plant and equipment;

   - A pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the intangible assets and property, plant and equipment.

2. *Inventory Valuation:*

   On a regular basis, the Company evaluates the value of its inventories. The obsolescence and the net realizable value are reviewed on an ongoing basis by management of the supply chain function based on its experience and knowledge of the current market conditions.

3. *Government Assistance and Research and Development Tax Credits*

   Government assistance and research and development tax credits are recorded in the Financial Statements under item "Research and Development" when there is reasonable assurance that the Company has complied with, and will continue to comply with, all of the conditions necessary to obtain the assistance. In general, the Company recognizes 80 % of the amount that it expects to receive at the time a claim is recorded.

4. *Share-Based Compensation:*

   The share-based compensation expense entailed by the award of stock options has been amortized using the graded vesting method. The options awarded pursuant to the Company's option plan generally vest over a three-year period and may be exercised within a maximum of 10 years of the award date. In evaluating the value of the share-based compensation, the Company uses judgment in assessing critical parameters such as the expected volatility, the risk free interest-rate, as well as the estimated number of options that will vest.

5. *Warrants Valuation:*

   Warrants issued as part of an equity issue may be exercised at any time after their issuance until their stated expiry. In evaluating the value of the warrants, the Company uses judgment in assessing critical parameters such as the volatility, the risk free interest rate and the likelihood that the Company will be able to exercise its option to accelerate the maturity of the warrants.

# Notes to the Consolidated Financial Statements

Years ended December 31, 2015 and 2014 (In Canadian $)

**2. Accounting Policies (cont'd)**

**Critical Accounting Judgments and Key Sources of Estimates Uncertainty (cont'd)**

6. *Deferred Income Taxes:*

A deferred income tax asset will be recognized in the financial statements only when the Company concludes that these tax assets will probably be materialized by shielding profits from taxes or otherwise. The tax asset amount will be recorded based on the enacted and substantively enacted income tax rates for the year in which the differences are expected to reverse.

7. *Functional Currency:*

The Company applies judgment in determining the functional currency of the Company and its subsidiary. Functional currency is determined based on the currency that influences the elaboration of sales prices and on the currency that influences labor, materials and others costs.

8. *Revenue Recognition:*

The Company applies judgment in determining the different deliverables related to the distribution agreement and estimating the revenues related to these elements.

Revenues from sales of products are recognized when products have been delivered to the distributor and collection is reasonably assured.

**3. Future Accounting Changes**

On December 18, 2014, the IASB issued Disclosure Initiative (Amendments to IAS 1) as part of its major initiative to improve presentation and disclosure in financial reports. The amendments to IAS 1 relate to (1) materiality; (2) order of the notes; (3) subtotals; (4) accounting policies; and (5) disaggregation and are designed to further encourage companies to apply professional judgment in determining what information to disclose in their financial statements. For example, the amendments make clear that materiality applies to the whole of financial statements and that the inclusion of immaterial information can inhibit the usefulness of financial disclosures. Furthermore, the amendments clarify that companies should use professional judgment in determining where and in what order information is presented in the financial disclosures. The amendments to IAS 1 are effective for annual periods beginning on or after January 1, 2016. Early adoption is permitted. The Company is currently evaluating the impact of the modification of this standard on its financial statements.

On July 25, 2014, the IASB completed its project on financial instruments by publishing amendments to IFRS 9 "Financial Instruments", which replaces the provisions of IAS 39 "Financial Instruments: Recognition and Measurement". IFRS 9, as amended, introduces a logical approach for the classification of financial assets, which is driven by cash flow characteristics and the business model in which an asset is held. This single, principle-based approach replaces existing rule-based requirements that are generally considered to be overly complex and difficult to apply. The new model also results in a single impairment model being applied to all financial instruments, thereby removing a source of complexity associated with previous accounting requirements. The IFRS 9 is effective for annual periods beginning on or after January 1, 2018. Early adoption is permitted. The Company is currently evaluating the impact of this new standard on its financial statements.

# Notes to the Consolidated Financial Statements

Years ended December 31, 2015 and 2014 (In Canadian $)

## 3. Future Accounting Changes (cont'd)

The IASB also published IFRS 15 - Revenue from Contracts with Customers, which replaces all the revenue standards and interpretations in IFRS, including IAS 11 - Construction Contracts and IAS 18 - Revenue. The IFRS 15 is effective for annual periods beginning on or after January 1, 2018, subject to approval by the Accounting Standards Board. Early adoption is permitted for IFRS 15. The Company is currently evaluating the impact of this new standard on its financial statements.

On January 29, 2016, the IASB published an amendment to IAS 7 - Statement of Cash Flows. The amendment, "Disclosure Initiative" clarifies that changes in liabilities arising from financing activities, including cash and non-cash changes, shall be disclosed in the Statement of Cash Flows. The provisions of this amendment will apply to financial statements beginning on or after January 1, 2017. Early adoption is permitted. The Company is currently evaluating the impact of this amendment on its financial statements.

On September 16, 2014, the IASB published an amendment to IFRS 10 – Consolidated Financial Statements and to IAS 28 - Investments in Associates and Joint Ventures. The amendment "Sale or Contribution of Assets between an Investor and its Associate or Joint Venture" clarifies the accounting for the gain or loss resulting from loss of control or from transfer of assets following a transaction with an associate or joint venture. Originally, the provisions of this amendment were supposed to apply prospectively to financial statements beginning on or after January 1, 2016. However, in December 2015, IASB published an amendment which defers the application to financial statements beginning on or after to a date to be determined. Early adoption is permitted. The Company is currently evaluating the impact of this amendment on its financial statements.

On January 13, 2016, the IASB published the standard IFRS 16 - Leases, which replace IAS 17, Leases. This new standard specifies how to recognize, measure, present and disclose leases. The standard provides a single lessee accounting model, requiring lessees to recognize assets and liabilities for all leases unless lease term is 12 months or less or the underlying asset has a low value. Lessor accounting remain substantially unchanged. The provisions of this new standard will apply to financial statements beginning on or after January 1, 2019. Early adoption is permitted if IFRS 15, Revenue from Contracts with customers is previously applied. The Company is currently evaluating the impact of this new standard on its financial statements.

## 4. Financial Expense (Income)

| | **2015** **$** | 2014 $ |
|---|---|---|
| Investment Income | **(128,081)** | (113,488) |
| Bank Charges | **41,226** | 23,169 |
| Foreign Exchange Gain | **(90,488)** | (2,328) |
| | **(177,343)** | (92,647) |

# Notes to the Consolidated Financial Statements

Years ended December 31, 2015 and 2014 (In Canadian $)

## 5. Additional Information on the Statements of Loss and Comprehensive Loss

Expenses included in functions supply chain, marketing, sales and service, research and development as well as administrative are the following:

| | **2015** **$** | 2014 $ |
|---|---|---|
| Salary and Other Benefits | **5,162,909** | 3,819,465 |
| Depreciation of Property, Plant and Equipment | **306,906** | 422,192 |
| Amortization of Intangible Assets | **214,199** | 240,521 |

### Severance expenses

During the year 2015, the Company recorded severance expenses to some of its employees for a total amount of $424,217 ($60,804 for the year 2014).

## 6. Financial Instruments

Cash and Cash Equivalents

| | **2015** **$** | 2014 $ |
|---|---|---|
| Cash | **8,706,919** | 5,973,446 |
| Investments with Maturities of Three Months or Less | | |
| Bank Guaranteed Investment Certificates | **8,807,100** | - |
| | **17,514,019** | 5,973,446 |

Bank Guaranteed Investment Certificates were rated AA- or better and had an average yield of 1.05%.

Short-term Investments

| | **2015** **$** | 2014 $ |
|---|---|---|
| Bank Guaranteed Investment Certificates | **3,401,163** | - |

Short-term Investment were rated AA- or better and had an average yield of 1.81%.

Bank Guaranteed Investment Certificates held by the Company are classified as level 2 under IFRS 13 because their valuation model is based on inputs other than quoted prices included in Level 1 that are observable for the assets, either directly or indirectly. Their fair value is calculated using the expected cash flows method discounted at the market rate on the measurement date.

No transfer between Level 1 and Level 2 of the fair value hierarchy has been made during the year ended December 31, 2015 (no transfer in 2014).

The Company is exposed to various risks, including the risks related to holding financial instruments. To manage the risk related to the use of financial instruments contained in the various investments that make up cash and cash equivalents and short-term investments, controls have been implemented and, in particular, an investment policy was adopted and implemented. The Company considers that the return on short-term investments is secondary to risk minimization and primarily aims to optimize cash flows from a maturity perspective. With respect to investments, the main risk exposures are as follows:

# Notes to the Consolidated Financial Statements

Years ended December 31, 2015 and 2014 (In Canadian $)

**6. Financial Instruments (cont'd)**

Market Risk

Market risk is the risk that the value of a financial instrument will fluctuate as a result of changes in the parameters underlying its measurement, particularly interest rates and exchange rates.

Interest Rate Risk

Interest rate risk exists when interest rate fluctuations modify the cash flows of the Company's investments, including the price at which an investment could be sold.

For the year ended December 31, 2015, if interest rates on that date had been 0.5% lower, and all other variables held constant, the net loss and comprehensive loss for the year would have been $23,873 lower (no impact for the year ended December 31, 2014), arising mainly as a result of an increase in the fair value of fixed rate financial assets classified at fair value through profit or loss. If the interest rates on that date had been 0.5% higher, all other variables being held constant, the net loss and comprehensive loss for the year would have been $23,669 higher (no impact for the year ended December 31, 2014), arising mainly as a result of a decrease in the fair value of fixed rate financial assets classified at fair value through profit or loss. The net loss and comprehensive loss therefore have substantially the same sensitivity to interest rate increases and interest rate decreases.

Currency Risk

The risk related to the exchange rate on financial instruments exists when monetary assets or liabilities are denominated in foreign currencies.

As at December 31, 2015, if the Canadian dollar had weakened 10 percent against the US dollar with all other variables held constant, the net loss and comprehensive loss for the year ended December 31, 2015 would have been $95,809 lower ($5,954 for the year ended December 31, 2014). Conversely, if the Canadian dollar had strengthened 10 percent against the US dollar with all other variables held constant, the net loss and comprehensive loss for the year ended December 31, 2015 would have been $95,809 higher ($5,954 for the year ended December 31, 2014).

Credit Risk

The use of financial instruments can create a credit risk entailing a risk of financial loss resulting from counterparty's inability or refusal to fully meet its contractual obligations. The Company's maximum exposure to credit risk is equal to the amounts recognized as receivables from clients, cash and cash equivalents and short-term investments.

Receivables from clients are from Getinge Infection Control and government-funded hospitals. By their size and their nature, the credit risk related to those receivables is reduced.

The Investment Policy established by the Company addresses management of credit risk exposures and permits investments in securities or instruments issued by, or guaranteed by, the Canadian federal or provincial governments, crown corporations as well as certain municipalities and financial institutions, provided that the issuer or guarantor benefits from a credit rating not less than A- on the rating scale of Standard and Poor's or the equivalent for other credit rating agencies. This policy sets limits to the size of exposures.

# Notes to the Consolidated Financial Statements

Years ended December 31, 2015 and 2014 (In Canadian $)

## 6. Financial Instruments (cont'd)

Credit Risk (cont'd)

As at December 31, 2015, the Company's short-term investments were rated by at least two recognized agencies and were within the credit ratings required by the Company's investment policy. As at December 31, 2014, the Company had no short-term investments.

Concentration Risk

Concentration risk exists when investments are made with multiple entities that share similar characteristics or when a large investment is made with a single entity. As at December 31, 2015 and December 31, 2014, there was no single investment that exceeded the limit required under the Company's Investment Policy.

Liquidity Risk

Liquidity risk represents the possibility that the Company may not be able to monetize its financial instruments so as to meet its financial commitments at the appropriate time and under reasonable conditions.

The Company's maximum exposure to liquidity risk is equal to the amounts recognized as accounts payable and accrued liabilities and these amounts will be paid in the following year. The Company manages this risk by maintaining sufficient liquidity available on demand to meet current and future financial obligations.

## 7. Accounts Receivable

| | **2015 $** | 2014 $ |
|---|---|---|
| Receivables from Clients | **152,870** | 118,549 |
| Government Credits Receivable | **388,060** | 139,145 |
| Receivables from warrants exercised | **69,000** | - |
| | **609,930** | 257,694 |

There were no bad debt allowances as at December 31, 2015 nor as at December 31, 2014.

## 8. Inventories

| | **2015 $** | 2014 $ |
|---|---|---|
| Raw Materials | **968,212** | 918,993 |
| Work in Progress | **378,173** | 310,166 |
| Finished Goods | **456,038** | 64,344 |
| | **1,802,423** | 1,293,503 |

Supply Chain expenses included a write-off of raw materials of $119,790 for the year ended December 31, 2015 ($170,903 for the year ended December 31, 2014).

# Notes to the Consolidated Financial Statements

Years ended December 31, 2015 and 2014 (In Canadian $)

## 9. Property, Plant and Equipment

| | LIFT TRUCK, EQUIPMENT AND TOOLS $ | STERILIZERS USED INTERNALLY $ | MARKETING AND ADMIN FURNITURE AND DEMONS-TRATION EQUIPMENT $ | MEDICAL DEVICES $ | COMPUTER EQUIPMENT $ | LEASEHOLD IMPROVE-MENTS $ | TOTAL $ |
|---|---|---|---|---|---|---|---|
| **Cost** | | | | | | | |
| Balance at January 1, 2015 | 1,212,893 | 709,248 | 201,456 | 536,421 | 130,990 | 215,327 | 3,006,335 |
| Additions | 57,852 | - | 79,534 | 44,014 | 60,407 | 11,125 | 252,932 |
| Balance at December 31, 2015 | 1,270,745 | 709,248 | 280,990 | 580,435 | 191,397 | 226,452 | 3,259,267 |
| **Accumulated Depreciation** | | | | | | | |
| Balance at January 1, 2015 | 1,083,395 | 449,694 | 159,790 | 445,190 | 112,122 | 198,629 | 2,448,820 |
| Depreciation | 47,341 | 129,503 | 18,316 | 74,455 | 24,281 | 13,010 | 306,906 |
| Balance at December 31, 2015 | 1,130,736 | 579,197 | 178,106 | 519,645 | 136,403 | 211,639 | 2,755,726 |
| **Net Carrying Amount at December 31, 2015** | 140,009 | 130,051 | 102,884 | 60,790 | 54,994 | 14,813 | 503,541 |

| | LIFT TRUCK, EQUIPMENT AND TOOLS $ | STERILIZERS USED INTERNALLY $ | MARKETING AND ADMIN FURNITURE AND DEMONS-TRATION EQUIPMENT $ | MEDICAL DEVICES $ | COMPUTER EQUIPMENT $ | LEASEHOLD IMPROVE-MENTS $ | TOTAL $ |
|---|---|---|---|---|---|---|---|
| **Cost** | | | | | | | |
| Balance at January 1, 2014 | 1,211,661 | 1,114,777 | 201,456 | 536,421 | 130,990 | 193,063 | 3,388,368 |
| Additions | 1,232 | - | - | - | - | 22,264 | 23,496 |
| Write-off | - | (405,529)[1)] | - | - | - | - | (405,529) |
| Balance at December 31, 2014 | 1,212,893 | 709,248 | 201,456 | 536,421 | 130,990 | 215,327 | 3,006,335 |
| **Accumulated Depreciation** | | | | | | | |
| Balance at January 1, 2014 | 1,007,540 | 569,130 | 147,927 | 342,914 | 79,695 | 193,063 | 2,340,269 |
| Depreciation | 75,855 | 194,205 | 11,863 | 102,276 | 32,427 | 5,566 | 422,192 |
| Elimination on Write-off | - | (313,641)[1)] | - | - | - | - | (313,641) |
| Balance at December 31, 2014 | 1,083,395 | 449,694 | 159,790 | 445,190 | 112,122 | 198,629 | 2,448,820 |
| **Net Carrying amount at December 31, 2014** | 129,498 | 259,554 | 41,666 | 91,231 | 18,868 | 16,698 | 557,515 |

[1)] In 2014, the Company wrote-off sterilizers used internally with an original cost of $405,529. The accumulated depreciation of $313,641 is related to the written off assets. The net loss of $91,888 related to this write-off was recorded in the research and development expenses in the Consolidated Statements of Loss and Comprehensive Loss.

# Notes to the Consolidated Financial Statements

Years ended December 31, 2015 and 2014 (In Canadian $)

## 10. Intangible Assets

| | TECHNOLOGY $ | PATENTS LICENSES TRADEMARKS $ | SOFTWARE WEB SITE $ | TOTAL $ |
|---|---|---|---|---|
| **Cost** | | | | |
| Balance at January 1, 2015 | 2,984,124 | 1,204,009 | 175,061 | 4,363,194 |
| Additions | - | 315,637 | 20,648 | 336,285 |
| Write-off | - | (321,635)[1)] | - | (321,635) |
| Balance at December 31, 2015 | 2,984,124 | 1,198,011 | 195,709 | 4,377,844 |
| **Accumulated Amortization** | | | | |
| Balance at January 1, 2015 | 1,490,096 | 269,727 | 170,718 | 1,930,541 |
| Amortization | 149,207 | 57,381 | 7,611 | 214,199 |
| Elimination on Write-off | - | (107,426)[1)] | - | (107,426) |
| Balance at December 31, 2015 | 1,639,303 | 219,682 | 178,329 | 2,037,314 |
| **Net Carrying Amount at December 31, 2015** | 1,344,821 | 978,329 | 17,380 | 2,340,530 |

[1)] In March 2015, the Company wrote off patents with an original cost of $321,635, and eliminated an amount of $107,426 in corresponding accumulated amortization. The net write-off amount of $214,209 is reported as part of the Administrative expenses in the Consolidated Statements of Loss and Comprehensive Loss.

| | TECHNOLOGY $ | PATENTS LICENSES TRADEMARKS $ | SOFTWARE WEB SITE $ | TOTAL $ |
|---|---|---|---|---|
| **Cost** | | | | |
| Balance at January 1, 2014 | 2,984,124 | 1,276,312 | 175,061 | 4,435,497 |
| Additions | - | 177,310 | - | 177,310 |
| Write-off | - | (249,613)[1)] | - | (249,613) |
| Balance at December 31, 2014 | 2,984,124 | 1,204,009 | 175,061 | 4,363,194 |
| **Accumulated Amortization** | | | | |
| Balance at January 1, 2014 | 1,340,889 | 286,023 | 152,494 | 1,779,406 |
| Amortization | 149,207 | 73,090 | 18,224 | 240,521 |
| Elimination on Write-off | - | (89,386)[1)] | - | (89,386) |
| Balance at December 31, 2014 | 1,490,096 | 269,727 | 170,718 | 1,930,541 |
| **Net Carrying Amount at December 31, 2014** | 1,494,028 | 934,282 | 4,343 | 2,432,653 |

[1)] In 2014, the Company wrote off patents with an original cost of $249,613. The accumulated amortization of $89,386 related to this write-off was eliminated. The net amount of $160,227 was incorporated to administrative expenses in the Consolidated Statements of Loss and Comprehensive Loss.

# Notes to the Consolidated Financial Statements

Years ended December 31, 2015 and 2014 (In Canadian $)

## 11. Deferred Revenues

On November 25, 2015, the Company entered into an exclusive distribution agreement with Getinge to distribute the STERIZONE® VP4 Sterilizer worldwide in exchange for US$7.5 million. The agreement includes performance requirements for five years as well as a formula for minimum unit shipments. Getinge will also receive ongoing technical support from the Company.

The Company recorded the US$7.5 million received as deferred revenues.

Sales under the agreement are made on a fixed price basis in US dollars to Getinge, who will be the only customer for the STERIZONE® VP4 Sterilizer while the agreement is in force.

Current deferred revenues also include the unamortized portion of prepaid service contracts covering a part of the installed base of STERIZONE® Sterilizers in Canada.

## 12. Share Capital

*Authorized:*

The authorized capital of the Company consists of an unlimited number of common shares and an unlimited number of preferred shares.

The common shares are voting, participating and without par value.

The preferred shares are non-voting and without par value. They have priority over the common shares for dividends and a distribution of their capital upon liquidation of the Company, and are issuable in series, each series bearing the number of shares, designation, rights, privileges, restrictions and conditions determined by the Board of Directors upon their issue.

*Issued:*

| | **2015** | | 2014 | |
|---|---|---|---|---|
| **Issued and Paid** | **Number of Common Shares** | **$** | Number of Common Shares | $ |
| Balance at Beginning | **73,399,656** | **104,499,449** | 73,000,906 | 104,028,949 |
| New Issue | **9,200,000** | **9,687,391** | - | - |
| Options Exercised | **42,333** | **85,772** | 75,000 | 75,525 |
| Warrants Exercised | **682,800** | **1,321,424** | 323,750 | 394,975 |
| **Balance at the End** | **83,324,789** | **115,594,036** | 73,399,656 | 104,499,449 |

On March 5, 2015, the Company closed a public equity issue of 9,200,000 units in the capital of the Company at the price of $1.25 per unit for aggregate gross proceeds of $11,500,000.

Each unit was comprised of one common share and one warrant entitling to acquire one common share at a price of $1.875 at any time prior to March 5, 2017. The warrants were subject to an accelerated expiry if, at any time after September 30, 2015, the published closing trade price of the common shares on the TSX is equal or greater than $2.00 for any 10 consecutive trading days. As at January 5, 2016, the Company announced the acceleration of the expiry date to February 4, 2016 (Note 23).

# Notes to the Consolidated Financial Statements

Years ended December 31, 2015 and 2014 (In Canadian $)

**12. Share Capital (cont'd)**

The compensation paid to the syndicate of underwriters was equal to a sale commission of 7% of the gross proceeds from the equity issue, and the issuance of 460,000 compensation warrants. Each compensation warrant enables its holder to purchase one common share of the Company at the price of $1.25 until March 5, 2016. These compensation warrants had a fair value of $108,100 (Note 14).

Net cash proceeds from the issue were $10,350,265 after payment of the underwriters' commission and the cash expenses of the issue. Expenses incurred in connection with the equity issue and the underwriters' commission were allocated to the Share Capital and the Reserve - Warrants based on a pro rata of their respective fair value estimated at $1.183 for each share issued and $0.067 for each issued warrant.

During the year ended December 31, 2015, pursuant to the Company's Stock Option Plan, option holders exercised stock options to subscribe 42,333 shares for a cash consideration of $53,316. During the year ended December 31, 2014, holders exercised 75,000 options for an aggregate cash consideration of $42,000.

During the year ended December 31, 2015, in connection with the exercise of warrants, the Company issued 682,800 common shares (323,750 for the year ended December 31, 2014) for a cash consideration of $1,280,250 ($323,750 for the year ended December 31, 2014).

**Shareholder Rights Plan Agreement**

The Board of Directors of $TSO_3$ has adopted a shareholder rights plan agreement (the "Plan") designed to foster fair treatment of all shareholders in connection with any take-over bid for $TSO_3$. $TSO_3$'s shareholders ratified the Plan at the annual and special shareholders meeting held on May 6, 2015. The Plan has been designed to give the Board and shareholders more time to fully consider any take-over bid and to provide the Board with more time to pursue, if appropriate, other alternatives to maximize shareholder value. The plan expires, unless its renewal is ratified, at every third annual meeting of shareholders of the Company. Consequently, the plan will either expire or be ratified at the 2018 Annual Meeting.

Under the terms of the Plan one right (a "Right") has been issued and attached to each voting share (each a "Share") of $TSO_3$ issued and outstanding as of the opening of business on October 25, 2011. One Right has and will, as the case may be, also be issued and attached to each Share subsequently issued. These Rights would become exercisable only when a person, including any party related to it, acquires or announces its intention to acquire 20% or more of the outstanding Shares of $TSO_3$ without complying with the "Permitted Bid" provisions of the Plan or, in certain cases, without the approval of the Board. Until such time, the Rights are not separable from the Shares, are not exercisable and no separate rights certificates are issued.

To qualify as a "Permitted Bid" under the Plan, a bid must, among other things: (1) be made to all holders of Shares of $TSO_3$; (2) provide that the Shares tendered will be taken up or paid for on a closing date which is not less than 60 days from the date of the bid and more than 50% of the Shares, other than those owned by the bidder and any related persons, were tendered and not withdrawn on that date; (3) provide that Shares tendered may be withdrawn by their holder at any time prior to closing; (4) provide that on the date where the Shares could be taken up and paid for, if more than 50% of the Shares held by holders independent from the bidder and any related persons were tendered, the bidder must disclose such fact in an announcement and the bid must remain open for another 10 days.

# Notes to the Consolidated Financial Statements

Years ended December 31, 2015 and 2014 (In Canadian $)

## 12. Share Capital (cont'd)

### Shareholder Rights Plan Agreement (cont'd)

Following the occurrence of an event which triggers the right to exercise the Rights and subject to the terms and conditions of the Plan, each Right would entitle the holders thereof, other than the acquiring person or any related persons, to exercise their Rights and purchase Shares of $TSO_3$ at a substantial discount to the market price at that time.

The agreement has no impact on the financial statements.

### Employee Stock Purchase Plan

On May 2, 2007, the Company set up an employee stock purchase plan for employees and executives. Eligible participants may contribute, in the form of payroll deductions, up to 5% of their base salary. The Company contributes an amount equal to 50% of the participant's total monthly contribution. Each month, the participants' and Company's contributions are transferred to an investment dealer who purchases, on the open market and promptly upon reception of the contributions, shares for a total purchase price equal to the amount of such contributions. For the year ended December 31, 2015, the Company contributed for a total amount of $12,658 ($16,232 in 2014).

## 13. Reserve – Share-Based Compensation

The Company's Board of Directors adopted a Share-Based Compensation plan in the form of an option plan designed solely for directors, executives, key employees and service providers of the Company. The plan was approved by the shareholders. The total number of common shares that can be issued under this plan from the Company's share capital was 8,161,000 as at December 31, 2015, (5,187,349 as at December 31, 2014). The options awarded pursuant to this plan generally vest over a three-year period and may be exercised within a maximum of 10 years from the date of award.

During the year ended December 31, 2015, the Company awarded 1,971,500 stock options, (637,500 for the year 2014) at a weighted average exercise price of $1.71 ($0.92 for the year 2014). The weighted average fair value of these stock options was $0.84 for the year 2015 ($0.48 for the year 2014).

The Share-Based Compensation expense pertaining to the award of options is amortized using the graded vesting method and represents a share-based compensation expense of $618,094 for the year ended December 31, 2015 ($171,645 for the year ended December 31, 2014) presented in the Consolidated Statements of Loss and Comprehensive loss in the functions based on the option holders.

The fair value of the stock options awarded is estimated using the Black-Scholes option pricing model under the following weighted average assumptions:

| | **2015** | 2014 |
|---|---|---|
| Weighted Average Share Price | **$1.71** | $0.93 |
| Exercise Price | **$1.71** | $0.92 |
| Risk Free Interest Rate | **1.36%** | 2.38% |
| Estimated Share Price Volatility | **44%** | 46% |
| Expected Life | **8 years** | 7 years |
| Expected Dividend Yield | **0%** | 0% |

# Notes to the Consolidated Financial Statements

Years ended December 31, 2015 and 2014 (In Canadian $)

**13. Reserve – Share-Based Compensation (cont'd)**

The Share-Based Compensation expenses takes into account an estimate of the number of options that will actually vest and be exercised. In addition, option pricing models such as the Black-Scholes model require highly subjective assumptions, including the assumed stock price volatility of the underlying shares. Volatility was estimated for the 2015 and 2014 awards on the basis of the historical volatility of the Company's share price prior to the date of award. Any change in the assumptions can materially affect the fair value estimates.

| | **2015** | | 2014 | |
|---|---|---|---|---|
| | **Number** | **Weighted Average Exercise Price $** | Number | Weighted Average Exercise Price $ |
| **Outstanding at beginning** | **3,369,535** | **0.97** | 3,164,684 | 1.05 |
| Granted | **1,971,500** | **1.71** | 637,500 | 0.92 |
| Exercised | **(42,333)** | **1.26** | (75,000) | 0.56 |
| Expired | **(48,467)** | **1.35** | (219,935) | 1.73 |
| Forfeited | **(256,667)** | **1.28** | (137,714) | 1.65 |
| **Outstanding at end** | **4,993,568** | **1.23** | 3,369,535 | 0.97 |
| **Exercisable at end** | **2,947,068** | **0.99** | 2,552,868 | 0.95 |

The following table summarizes certain information regarding the stock options of the Company as at December 31, 2015:

| | **Outstanding Options** | | **Exercisable Options** | |
|---|---|---|---|---|
| **Exercise Price** | Number | Average Remaining Contractual Life (year) | Number | Average Remaining Contractual Life (year) |
| $0.37 to $0.94 | 2,082,500 | 4.25 | 1,767,500 | 3.49 |
| $1.08 to $1.97 | 2,132,600 | 6.12 | 982,600 | 6.24 |
| $2.01 to $3.45 | 778,468 | 7.67 | 196,968 | 0.89 |
| | 4,993,568 | 5.58 | 2,947,068 | 4.23 |

The following table summarizes certain information regarding the stock options of the Company as at December 31, 2014:

| | **Outstanding Options** | | **Exercisable Options** | |
|---|---|---|---|---|
| **Exercise Price** | Number | Average Remaining Contractual Life (year) | Number | Average Remaining Contractual Life (year) |
| $0.37 to $0.94 | 2,096,000 | 5.27 | 1,581,833 | 3.97 |
| $1.08 to $1.97 | 1,076,567 | 6.68 | 774,067 | 6.05 |
| $2.20 to $3.45 | 196,968 | 1.89 | 196,968 | 1.89 |
| | 3,369,535 | 5.52 | 2,552,868 | 4.44 |

# Notes to the Consolidated Financial Statements

Years ended December 31, 2015 and 2014 (In Canadian $)

## 14. Reserve – Warrants

| | Number | 2015 Weighted Average Exercise Price $ | Number | 2014 Weighted Average Exercise Price $ |
|---|---|---|---|---|
| **Outstanding at Beginning** | **-** | **-** | 350,000 | 1.00 |
| Issued | **9,660,000** | **1.85** | - | - |
| Exercised | **(682,800)** | **1.88** | (323,750) | 1.00 |
| Expired | **-** | **-** | (26,250) | 1.00 |
| **Outstanding at End** | **8,977,200** | **1.85** | - | - |
| **Exercisable at End** | **8,977,200** | **1.85** | - | - |

During the first quarter of 2015, 9,200,000 warrants were issued to purchasers of units in connection with the equity issue closed on March 5, 2015. These warrants allow their holders to purchase 9,200,000 shares at a price of $1.875 per share until their March 5, 2017 expiry. On January 5, 2016, the Company has prevailed itself of an option to accelerate the maturity of the warrants to February 4, 2016 (Note 23). On March 5, 2015, the fair value of each of these warrants was $0.067, for an aggregate value of $616,400.

In addition, 460,000 warrants were issued as part of the compensation to the underwriters in connection with the equity issue closed on March 5, 2015. Each of these 460,000 compensation warrants is exercisable to acquire one common share at the exercise price of $1.25 until March 5, 2016. On March 5, 2015, the fair value of each of these warrants was $0.235, for an aggregate value of $108,100.

The fair value of the warrants issued was estimated using the Black-Scholes option pricing model using the following assumptions:

| | 2015 | 2014 |
|---|---|---|
| Weighted Average Share Price | **$1.27** | **-** |
| Exercise Price | **$1.85** | **-** |
| Risk Free Interest Rate | **1.45%** | **-** |
| Estimated Share Price Volatility | **43.5%** | **-** |
| Expected Life (without the option to accelerate the maturity) | **23 months** | **-** |
| Expected Dividend Yield | **0%** | **-** |

At any time when warrants expire without being exercised or are being cancelled, the Company is authorized to transfer to the Deficit the corresponding amount that was included in the Reserve for Warrants. Consequently, upon the expiration of 26,250 warrants on September 4, 2014, the corresponding reserve of $5,775 was transferred to the Deficit.

# Notes to the Consolidated Financial Statements

Years ended December 31, 2015 and 2014 (In Canadian $)

## 15. Capital Management

The Company needs capital primarily to finance its sale and marketing activities, its production, its research and development, its supply chain, administrative and communication expenses, its working capital and its capital expenditures. The Company's capital is comprised of share capital, reserve for share-based compensation and reserve for warrants. Depending on the quality of the credit structure of a prospective debt transaction and prevailing market conditions, the Company could finance a portion of its cash needs through debt issues. However, given its history of negative earnings, it is unlikely at the present time that the Company could access senior debt financing in any sizable amount from traditional sources such as commercial banks. In the past, the Company has financed its activities through public and private financings and, to a small extent, through government grants and tax credits.

## 16. Additional Information Relating to Cash Flows

| | **2015** **$** | 2014 $ |
|---|---|---|
| *Change in Non-Cash Operating Working Capital Items* | | |
| Decrease (Increase) in Current Assets | | |
| Accounts Receivable | **(352,236)** | 907,972 |
| Inventories | **(508,920)** | 113,908 |
| Prepaid Expenses | **(7,352)** | (48,380) |
| Increase (Decrease) in Current Liabilities | | |
| Accounts Payable and Accrued Liabilities | **1,146,078** | 97,873 |
| Deferred Revenues | **(30,394)** | (9,886) |
| Deferred Revenues related to the License Fee | **10,380,000** | - |
| | **10,627,176** | 1,061,487 |
| Inventories transferred to Property, Plant and Equipment | **(32,509)** | - |
| Warrants exercised receivable | **69,000** | - |
| | **10,663,667** | 1,061,487 |
| *Research and Development Tax Credits* | | |
| Received | **30,622** | 1,521,102 |

# Notes to the Consolidated Financial Statements

Years ended December 31, 2015 and 2014 (In Canadian $)

## 17. Related Party Transactions

Compensation of Key Management Personnel

People in key management positions have authority and responsibility for planning, directing and controlling the activities of the Company. Key management comprises the Chief Executive Officer, the Chief Financial Officer, other vice-presidents and directors. The remuneration of key management personnel during the year was as follows:

| | **2015** **$** | 2014 $ |
|---|---|---|
| Short-term salaries and other benefits | **1,532,612** | 962,069 |
| Post-employment Benefits | **394,139** | 13,194 |
| Share-Based Payments | **3,241** | 4,471 |
| Option-Based Awards[(1)] | **168,665** | 99,846 |
| | **2,098,658** | 1,079,580 |

(1) Option-Based awards reflect the amount of the expenses accounted for during the year for stock-options and presented as part of the Share-Based Compensation.

The compensation of key executives is determined by the Human Resources Committee taking into consideration the individual performance and market trends.

## 18. Income Taxes

For tax purposes, the losses from operations incurred during the year can be applied against future taxable income.

As at December 31, 2015, the accumulated tax losses that can be carried forward are as follows:

| | **Loss carry-forwards** | |
|---|---|---|
| **Expiry Date** | **Federal** **$** | **Provincial** **$** |
| 2035 | 7,333,000 | 7,251,000 |
| 2034 | 5,727,000 | 5,444,000 |
| 2033 | 7,899,000 | 7,552,000 |
| 2032 | 4,933,000 | 4,612,000 |
| 2031 | 6,185,000 | 5,795,000 |
| 2030 | 6,594,000 | 6,327,000 |
| 2029 | 7,570,000 | 7,122,000 |
| 2028 | 8,052,000 | 8,040,000 |
| 2027 | 6,224,000 | 6,822,000 |
| 2026 | 5,481,000 | 5,820,000 |
| | 65,998,000 | 64,785,000 |

As at December 31, 2015, based on an effective rate of 15% for federal taxes (15% in 2014) and 11.9% for provincial taxes (11.9% in 2014), the undiscounted value of tax losses carried forward is $17,609,000 ($17,023,000 in 2014).

# Notes to the Consolidated Financial Statements

Years ended December 31, 2015 and 2014 (In Canadian $)

**18. Income Taxes (cont'd)**

As at December 31, 2015, in addition to these tax losses carried forward, the Company has unclaimed research and development expenses of $12,992,000 at the federal level ($12,863,920 in 2014) and $20,014,000 at the provincial level ($19,810,000 in 2014) and $1,485,000 in financing costs ($906,000 in 2014) that can be carried forward to reduce future taxable income. The unrealized tax benefit related to these items is estimated at $4,730,000 ($4,531,000 in 2014).

With respect to property, plant and equipment, the Company has a deferred income tax related to the tax cost that is higher than the carrying amount of these capital assets. The unrecorded eventual tax benefit related to that difference is evaluated at $1,220,000 ($1,065,000 in 2014).

In addition, as of December 31, 2015, the Company has $3,558,000 ($3,523,000 in 2014) in additional tax credits representing the outstanding and unrecorded portion of the federal research and development tax credit receivable.

Furthermore, the cost of intangible assets for tax purposes was $564,000 ($564,000 in 2014) [carrying amount of $1,345,000 ($1,494,000 in 2014)] resulting from the Company taking advantage of provisions in the federal and provincial income tax laws with respect to rollovers. Deferred income taxes liability of $124,000 ($154,000 in 2014) resulting from the difference between the carrying value and the tax value of intangible assets has been recorded. As well, a deferred income taxes asset of the same amount has been recorded relating to the item previously presented.

The deferred income tax assets related to such losses and non-refundable investment tax credits will not be recognized in the consolidated financial statements until the Company is able to conclude that these unrecorded tax assets are probable to be materialized by shielding profits from taxes or otherwise. If the Company had concluded on December 31, 2015 that these items would likely be materialized, based on an effective rate of 15% for federal taxes (15% in 2014) and 11.9% for provincial taxes (11.9% in 2014), it would have recorded an aggregate net amount of $26,036,000 in tax assets ($25,020,000 as at December 31, 2014) and a corresponding increase in earnings and shareholders' equity.

**19. Research and Development Tax Credits**

The Company claims two different types of tax credits, one type is refundable regardless of the level of taxable income, and the other can only be used to offset a tax liability. At the present time, in accordance with the Company's accounting policies, the non-refundable credits are not recorded.

For the purpose of the establishment of these tax credits, eligible research and development expenses incurred during the fiscal year 2015 totaled $195,000 ($345,900 in 2014).

The Company also qualifies for tax credits refundable scientific research, $81,000 at as December 31, 2015 ($198,000 in 2014).

The tax credits claimed for fiscal years ended December 31, 2015 and December 31, 2014 have not been reviewed by the tax authorities. Consequently, the amount of tax credits that will be awarded could differ from the ones already recorded.

# Notes to the Consolidated Financial Statements

Years ended December 31, 2015 and 2014 (In Canadian $)

## 20. Segmented Information

The Company is structured as a single operating segment.

Except property, plant and equipment for a net value of $95,441 ($0 as at December 31, 2014) located in the United-States, all are located in Canada.

Sales are allocated between geographic areas based on the location of the client and are as follows for years ended December 31, 2015 and 2014:

| | **2015** | | 2014 | |
|---|---|---|---|---|
| | **$** | **%** | **$** | **%** |
| Canada | **464,689** | **28** | 351,783 | 81 |
| United States | **1,168,555** | **72** | 81,204 | 19 |
| | **1,633,244** | **100** | 432,987 | 100 |

The Company has earned an important part of its revenues from Getinge. For the year 2015, these revenues represented 71% of the Company's sales (none in 2014). Shipments to that client were made in the United-States.

## 21. Loss per Share

The following table reconciles the basic and diluted loss per share for the years ended December 31:

| | **2015** | 2014 |
|---|---|---|
| | **$** | $ |
| Net Loss | | |
| Basic and Diluted | **(8,133,462)** | (5,947,989) |
| Number of Shares | | |
| Weighted Average Number of Outstanding Shares | **81,263,710** | 73,123,794 |
| Loss per Share | | |
| Basic and Diluted [(1)] | **(0.10)** | (0.08) |

1) The weighted average number of outstanding shares is the same number used in the calculation of the diluted net loss per share since the inclusion of common shares resulting from the potential exercise of options and warrants is antidilutive in the calculation of the diluted loss per share. If the Company had a positive profit, the weighted average number of outstanding shares would have been increased by 5,256,600 as of December 31, 2015 (2,542,467 as of December 31, 2014) for the calculation of the diluted net loss per share.

## 22. Contractual Commitments

As at December 31, 2015, the contractual commitments in the fiscal years to come are as follows:

| | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|
| | $ | $ | $ | $ | $ |
| Operating leases and service contracts | 225,000 | 107,000 | 87,000 | 86,000 | 57,000 |

Operating leases relate to leases of premises with lease terms of one and five years. The Company does not have an option to purchase the leased premises at the expiry of the lease periods. For the year ended December 31, 2015, lease expenses were $179,965 ($145,025 for the year ended December 31, 2014).

# Notes to the Consolidated Financial Statements

Years ended December 31, 2015 and 2014 (In Canadian $)

## 23. Subsequent event

Warrants were issued on the closing date of the bought deal offering by prospectus in March 2015. The warrants were subject to an accelerated expiry if at any time after September 30, 2015, the published closing trade price of the Company's common shares on the TSX was equal to or greater than $2.00 for 10 consecutive trading days.

On January 5, 2016, the Company accelerated the expiry date of the warrants to February 4, 2016. Of the 8.5 million warrants subject to expiry acceleration as at January 5, 2016, 7.2 million were exercised and 1.3 million expired unexercised. The total proceeds from the 7.2 million warrants subject to an accelerated expiry associated with the 2015 financing equaled $13.5 million leaving the Company, as at February 5, 2016, with more than $32 million in cash, cash equivalents and short-term investments when including all proceeds for warrant exercises. Shares issued in the first quarter related to warrants exercised were 7.7 million.

The compensation paid to the syndicate of underwriters included the issuance of 460,000 compensation warrants. Each compensation warrant enables its holder to purchase one common share of the Company at the price of $1.25 until March 5, 2016. From January 1, 2016 to the expiration date of March 5, 2016, all compensation warrants had been exercised for total cash proceeds of $575,000.

## 24. Approval of Financial Statements

The consolidated financial statements were approved by the Board of Directors on March 22, 2016.

# Directors

**Germain Carrière** [3]

Chairman of the Board of Directors
Corporate Director

**Pierre Désy** [1) 3) 4)]

Corporate Director

**Jean Lamarre** [2) 3) 4)]

President, Lamarre Consultants
Corporate Director

**Claude Michaud** [1) 2) 4)]

Corporate Director

**Jean-Pierre Robert** [1) 2) 4)]

Corporate Director

**Richard M. Rumble** [4)]

President and Chief Executive Officer, $TSO_3$

**Steve West** [4)]

Corporate Director

1) Member of the Audit Committee
2) Member of the Human Resources
3) Member of the Corporate Governance Committee
4) Member of the Advisory Committee

# Investor's Information

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Banque Nationale du Canada

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**INDEPENDENT AUDITOR**
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**INTELLECTUAL PROPERTY SOLICITORS**
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**$TSO_3$ - INVESTOR RELATIONS**
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**$TSO_3$ Corporation**
1636 American Way
Myrtle Beach, SC 29577

Telephone: 843 839-0403
Fax: 843 839-1118
E-mail: info@tso3.com

Ticker Symbol: TOS
Listing: TXS
www.tso3.com

## Annual Shareholders' Meeting

Wednesday, May 4, 2016 at 10:30 am
*Musée National des beaux-arts du Québec, Boardroom Multi*
National Battlefields Park
Québec City, QC G1R 5H3

**R.M. (Ric) Rumble**
President and CEO
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**Glen Kayll**
Chief Financial Officer
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**Germain Carrière**
Chairman
Germain.carriere@gmail.com