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**27 February 2017**

# AirXpanders Full Year Financial Results

**Highlights**

- Targeted U.S. Market Release commenced post FDA *de novo* clearance
- Total revenue for the year ended 31 December 2016, was US$570,316 as sales of the Aeroform® Tissue Expander System saw an increase of 95% over 2015
- Operating expenses of US$15,184,431 reflecting the investment in sales, market and administrative expenses in preparation for U.S. commercial launch, and the continued scaling up of manufacturing
- Net loss after tax was US$19,422,897
- Cash position US$11,507,151 as of 31 December 2016

**PALO ALTO, CA, United States:** AirXpanders Inc. (ASX:AXP) a medical device company focused on the design, manufacture, sale and distribution of the AeroForm® Tissue Expander System, today released its Appendix 4E – Full Year Financial Results for the period ended 31 December 2016.

In the first full year of following the launch of the AeroForm® Tissue Expander System in the Australian market, the Company reported revenues of US$570,316. Revenue growth was in the mid twenty percent range for three consecutive quarters through December 2016.

Expenditure was US$15,150,371, up from US$9,467,422, reflecting increased investment in sales, marketing and general administrative expenses in preparation for commercial launch in the U.S., as well as increased spending on the scale up of manufacturing capability.

In December 2016 the Company received U.S. Food and Administration (FDA) *de novo* clearance for the AeroForm® Tissue Expander System. Shortly thereafter, AirXpanders commenced its targeted market release plans.

In February 2017, the Company completed an equity placement for 48,913,044 CHESS Depositary Interests (CDIs) (representing 16,304,348 shares of Class A Common Stock) at A$0.92 per CDI to raise A$45 Million. The funds raised will be utilised to build inventory, accelerate investment for U.S. sales and marketing, complete expansion of commercial manufacturing capacity in Costa Rica; and for general working capital.

The Company had cash, deposits at call and long term fixed interest term deposits of US$11,507,151 at 31 December 2016.

- ENDS -

| *Company* | *Investor relations* |
|---|---|
| Scott Dodson<br>President & CEO<br>Tel: +1 (650)-390-9008<br>Email: sdodson@airxpanders.com | Kyahn Williamson<br>WE Buchan<br>Tel: +61 (3) 9866 4722 / + 61 (0)401018828<br>Email: kwilliamson@buchanwe.com.au |

**About AirXpanders:**

Founded in 2005, AirXpanders, Inc. (www.airxpanders.com) designs, manufactures and markets innovative medical devices to improve breast reconstruction. The company's AeroForm Tissue Expander System, is used in patients undergoing two-stage breast reconstruction following mastectomy. Headquartered in Palo Alto, California, AirXpanders' vision is to be the global leader in reconstructive surgery products and to become the standard of care in two-stage breast reconstruction. AirXpanders is a publically listed company on the Australian Securities Exchange under the symbol "AXP." AeroForm was granted U.S. FDA de novo marketing authorisation in 2016, first CE mark in Europe in 2012 and is currently licensed for sale in Australia.

**Foreign Ownership Restriction**

AirXpanders' CHESS Depositary Interests (CDIs) are issued in reliance on the exemption from registration contained in Regulation S of the US Securities Act of 1933 (Securities Act) for offers or sales which are made outside the US. Accordingly, the CDIs have not been, and will not be, registered under the Securities Act or the laws of any state or other jurisdiction in the US. The holders of AirXpanders' CDIs are unable to sell the CDIs into the US or to a US person unless the re-sale of the CDIs is registered under the Securities Act or an exemption is available. Hedging transactions with regard to the CDIs may only be conducted in accordance with the Securities Act.

For more information, refer to the Company's website at www.airxpanders.com.

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# APPENDIX 4E (RULE 4.3A)

## PRELIMINARY FINAL REPORT FOR THE YEAR ENDED 31 DECEMBER 2016

### RESULTS FOR ANNOUNCEMENT TO THE MARKET

(All comparisons to year ended 31 December 2015)

| | $USD | up/down | % movement |
|---|---|---|---|
| **Revenue from ordinary activities** | $570,316 | up | 95% |
| Loss after tax from ordinary activities attributable to members | ($19,422,897) | up | 74% |
| Net loss after tax attributable to members | ($19,422,897) | up | 74% |

| **Dividend information** | Amount per security $USD | Franked amount per security $USD | Tax rate for franking credit |
|---|---|---|---|
| Interim dividend | Nil | Nil | N/A |
| Previous corresponding dividend | Nil | Nil | N/A |

| **Net tangible asset backing** | 31 Dec 2016 $USD | 31 Dec 2015 $USD |
|---|---|---|
| Net tangible asset per share of Class A Common Stock (Share) of the Company | $0.26 | $0.32 |
| Net tangible asset per CDI assuming all Shares held as CDIs | $0.09 | $0.19 |

- **Annual financial results:** This report is based on the accompanying consolidated 2016 Financial Statements which have been audited by SingerLewak, LLP with the Independent Auditor's Report included in the 2016 Financial Statements.
- **Changes in control over entities:** There were no entities over which control has been gained or lost during 2016.
- **Details of dividends and dividend reinvestment plans:** No dividends have been declared or proposed.
- **Details of associates or joint ventures:** N/A
- **Set of accounting standards used in compiling the report:** The audited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the U.S. (US GAAP) and are denominated in U.S. dollars.
- **Details of audit disputes or audit qualification:** None.

**A commentary on the results for the period:**

The net loss for the year increased to $19,422,897 compared to $11,161,345 for the previous corresponding period.

Total operating expenses increased to $15,150,371 from $9,467,422 for the previous corresponding period, reflecting increased investment in sales, marketing and general administrative expenses in preparation for commercial launch in the United States, as well as increased spending on the scale up of manufacturing capability.

The Company had cash, deposits at call and long term fixed interest term deposits of US$11,507,151 at 31 December 2016.

The Company is entering the new financial year in a secure position from a business and financial perspective. In December 2016, the Company received FDA de novo clearance to market and sell the Aeroform® Tissue Expansion System in the US. Subsequent to 31 December 2016, the Company raised approximately $32.6 million (45 million AUD) through an equity placement.

The Company operated in one segment only during the period and there were no returns to shareholders or share buy backs.

Please also refer to the separate update on the full year financial results of the Company and the Company's audited consolidated financial statements, with accompanying notes, which are attached hereto.

**Annual Meeting of Stockholders**

The Annual Meeting of Stockholders of the Company will be held at *Johnson Winter & Slattery's Sydney office* at Level 25, 20 Bond Street Sydney, New South Wales, Australia on Tuesday, 23 May 2017 at 9.00am Australian Eastern Standard Time (Monday, 22 May 2017 at 4.00pm U.S. Pacific Standard Time).

# AIRXPANDERS, INC.

Consolidated Financial Statements as of and for the
Years Ended December 31, 2016 and 2015

SingerLewak
Accountants & Consultants

## Independent Auditor's Report

To the Board of Directors and Stockholders of
AirXpanders, Inc.
Palo Alto, California

### Report on the Financial Statements

We have audited the accompanying consolidated financial statements of AirXpanders, Inc. (collectively, the "Company"), which comprise the consolidated balance sheets as of December 31, 2016 and 2015, the related consolidated statements of operations and comprehensive loss, stockholders' equity and cash flows for the years then ended, and the related notes to the consolidated financial statements (collectively, the "financial statements").

### Management's Responsibility for the Financial Statements

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

### Auditor's Responsibility

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

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

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

**Opinion**

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of AirXpanders, Inc. and its subsidiary as of December 31, 2016 and 2015, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

SingerLewak LLP

SingerLewak LLP

February 27, 2017

**AIRXPANDERS, INC.**
**CONSOLIDATED BALANCE SHEETS**
**December 31, 2016 and 2015**

**ASSETS**

| | 2016 | 2015 |
|---|---|---|
| **Current assets** | | |
| Cash and cash equivalents | $ 11,477,151 | $ 19,112,802 |
| Accounts receivable | 118,299 | 76,884 |
| Inventory | 1,413,100 | 527,020 |
| Prepaid expenses and other current assets | 557,758 | 194,593 |
| Total current assets | 13,566,308 | 19,911,299 |
| **Property and equipment, net** | 1,879,288 | 909,662 |
| **Other assets** | 83,425 | 76,542 |
| **Total assets** | **$ 15,529,021** | **$ 20,897,503** |

**LIABILITIES AND STOCKHOLDERS' EQUITY**

| | 2016 | 2015 |
|---|---|---|
| **Current liabilities** | | |
| Current portion of long-term debt, net of discount | $ 1,195,335 | $ 1,500,000 |
| Accounts payable | 1,248,970 | 874,396 |
| Accrued expenses | 915,547 | 393,959 |
| Total current liabilities | 3,359,852 | 2,768,355 |
| **Long-term debt, less current portion, net of discount** | - | 1,083,933 |
| Total liabilities | 3,359,852 | 3,852,288 |
| **Commitments (Note 8)** | | |
| **Stockholders' equity** | | |
| Preferred stock, $0.001 par value; 10,000,000 authorized at December 31, 2016 and 2015; no shares issued and and outstanding at December 31, 2016 and 2015 | - | - |
| Class A common stock; $0.001 par value, 200,000,000 authorized at December 31, 2016 and 2015; 79,241,708 and 70,427,195 shares issued and outstanding at December 31, 2016 and 2015 | 79,241 | 70,426 |
| Class B common stock; $0.001 par value, 100,000,000 authorized at December 31, 2016 and 2015; no shares issued and and outstanding at December 31, 2016 and 2015 | - | - |
| Additional paid-in capital | 78,418,222 | 63,880,186 |
| Accumulated deficit | (66,328,294) | (46,905,397) |
| Total stockholders' equity | 12,169,169 | 17,045,215 |
| **Total liabilities and stockholders' equity** | **$ 15,529,021** | **$ 20,897,503** |

**See accompanying notes to consolidated financial statements**

**AIRXPANDERS, INC.**
**CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHESIVE LOSS**
**For the Years Ended December 31, 2016 and 2015**

| | 2016 | 2015 |
|---|---|---|
| **Revenue** | $ 570,316 | $ 292,608 |
| **Cost of goods sold** | 4,543,023 | 1,905,589 |
| **Gross loss** | (3,972,707) | (1,612,981) |
| **Operating expenses** | | |
| Research and development | 5,077,527 | 3,131,118 |
| Clinical trials and regulatory | 2,087,075 | 1,696,231 |
| Selling, general and administrative | 7,985,769 | 4,640,073 |
| Total operating expenses | 15,150,371 | 9,467,422 |
| **Operating loss** | (19,123,078) | (11,080,403) |
| **Interest expense** | 249,054 | 421,996 |
| **Other expense (income), net** | 49,965 | (341,054) |
| **Operating loss before income tax provision** | (19,422,097) | (11,161,345) |
| Provision for income taxes | 800 | - |
| **Net loss and comprehensive loss** | $ (19,422,897) | $ (11,161,345) |
| **Net loss per common share:** | | |
| **Basic and diluted** | $ (0.26) | $ (0.32) |
| **Weighted-average number of shares used in computing net loss per share:** | | |
| **Basic and diluted** | 74,793,530 | 35,377,588 |

**See accompanying notes to consolidated financial statements**

**AIRXPANDERS, INC.**

**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**

**For the years ended December 31, 2016 and 2015**

| | Convertible Preferred Stock | | Common Stock | | | | |
|---|---|---|---|---|---|---|---|
| | Issued and Outstanding Shares | Amount | Issued and Outstanding Shares | Amount | Additional Paid-In Capital | Accumulated Deficit | Total Stockholders' Equity |
| **Balance, December 31, 2014** | **130,509,868** | **$ 130,510** | **901,665** | **$ 902** | **$ 33,425,263** | **$ (35,744,052)** | **$ (2,187,377)** |
| | | | | | | | - |
| Issuance of common stock for cash (net of issuance costs of $2,872,649) | - | - | 25,217,180 | 25,217 | 25,055,056 | - | 25,080,273 |
| Exercise of warrants to purchase common stock | - | - | 9,780,489 | 9,780 | 39,122 | - | 48,902 |
| Exercise of stock options | - | - | 2,965 | 3 | 520 | - | 523 |
| Conversion of convertible bridge notes payable and accrued interest of $70,233 into common stock | - | - | 4,412,474 | 4,412 | 5,025,808 | - | 5,030,220 |
| Conversion of convertible preferred stock into common stock | (130,509,868) | (130,510) | 30,112,422 | 30,112 | 100,398 | - | - |
| Conversion of warrants to purchase preferred stock into warrants to purchase common stock | - | - | - | - | 122,516 | - | 122,516 |
| Stock-based compensation | - | - | - | - | 111,503 | - | 111,503 |
| Net loss | - | - | - | - | - | (11,161,345) | (11,161,345) |
| **Balance, December 31, 2015** | **-** | **$ -** | **70,427,195** | **$ 70,426** | **$ 63,880,186** | **$ (46,905,397)** | **$ 17,045,215** |
| | | | | | | - | - |
| Issuance of common stock for cash (net of issuance costs of $731,489) | | - | 8,771,930 | 8,772 | 14,150,085 | | 14,158,857 |
| Exercise of stock options | | - | 42,583 | 43 | 10,577 | | 10,620 |
| Stock-based compensation | | | | | 377,374 | | 377,374 |
| Net loss | - | - | - | - | - | (19,422,897) | (19,422,897) |
| **Balance, December 31, 2016** | **-** | **$ -** | **79,241,708** | **$ 79,241** | **$ 78,418,222** | **$ (66,328,294)** | **$ 12,169,169** |

**See accompanying notes to consolidated financial statements**

**AIRXPANDERS, INC.**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**For the years ended December 31, 2016 and 2015**

| | 2016 | 2015 |
|---|---|---|
| **Cash flows from operating activities** | | |
| Net loss | $ (19,422,897) | $ (11,161,345) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization | 237,291 | 85,619 |
| Amortization of debt discount and deferred issuance cost | 111,403 | 36,566 |
| Loss of disposal of assets | 13,584 | - |
| Interest on convertible bridge notes payable converted to common stock | - | 70,233 |
| Change in fair value of warrant liabilities | - | (41,622) |
| Inventory provision | 1,537,090 | 527,444 |
| Stock-based compensation | 377,374 | 111,503 |
| Changes in operating assets and liabilities | | |
| Accounts receivable | (41,415) | (76,884) |
| Inventory | (2,423,170) | (882,796) |
| Prepaid expenses and other assets | (389,746) | (175,056) |
| Accounts payable | 324,635 | 472,571 |
| Accrued expenses | 521,588 | 198,794 |
| Net cash used in operating activities | (19,154,263) | (10,834,973) |
| **Cash flows from investing activities** | | |
| Purchase of property and equipment | (1,150,865) | (839,975) |
| Net cash used in investing activities | (1,150,865) | (839,975) |
| **Cash flows from financing activities** | | |
| Proceeds from convertible bridge notes payable | - | 4,959,987 |
| Principal payments on notes payable | (1,500,000) | (952,671) |
| Proceeds from issuance of common stock, net of issuance costs | 14,158,857 | 25,080,273 |
| Proceeds from exercise of stock options | 10,620 | 523 |
| Proceeds from exercise of warrants for common stock | - | 48,902 |
| Net cash provided by financing activities | 12,669,477 | 29,137,014 |
| **Net (decrease) increase in cash and cash equivalents** | (7,635,651) | 17,462,066 |
| **Cash and cash equivalents - beginning of period** | 19,112,802 | 1,650,736 |
| **Cash and cash equivalents - end of period** | **$ 11,477,151** | **$ 19,112,802** |
| **Supplemental disclosure** | | |
| Cash paid for interest | **$ 137,653** | **$ 240,144** |
| Cash paid for taxes | **$ 800** | **$ 800** |
| **Supplemental schedule of noncash investing and financing activities:** | | |
| Conversion of preferred stock to common stock in connection with intial public offering | **$ -** | **$ 34,632,758** |
| Conversion of convertible bridge notes payable and accrued interest to common stock in connection with intial public offering | **$ -** | **$ 5,030,220** |
| Conversion of warrant liabilities to equity | **$ -** | **$ 122,516** |

**See accompanying notes to consolidated financial statements**

## NOTE 1 – DESCRIPTION OF BUSINESS

AirXpanders, Inc. and its Australian subsidiary ("AirXpanders" or the "Company") is a Delaware corporation formed on March 17, 2005, and is headquartered in Palo Alto, California. The Company designs, manufacturers and markets medical devices to improve breast reconstruction. The Company's AeroForm Tissue Expander System is used in patients undergoing two-stage breast reconstruction following mastectomy. AeroForm was granted U.S. FDA de novo marketing authorization in 2016, its first CE mark in Europe in 2012 and is currently licensed for sale in Australia. To date, the Company has been primarily engaged in developing and launching its initial product technology, building the manufacturing infrastructure to support commercialization efforts, recruiting key personnel and raising capital.

## NOTE 2 – LIQUIDITY

The accompanying consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the settlement of liabilities and commitments in the normal course of business for the foreseeable future. The Company has incurred net losses and cash flow deficits from operations since its inception and has an accumulated deficit of $66,328,294 at December 31, 2016. To date, the Company's products have been approved for marketing and sales in Europe, Australia and the United States, and the Company started selling its product in Australia in 2015, and in the United States in 2017. Management expects operating losses and cash flow deficits to continue for the foreseeable future. The Company's ability to achieve profitability is dependent primarily on its ability to gain market share in the U.S, build and maintain manufacturing capacity to support commercial launch in the US and obtain a more profitable per unit manufacturing cost for its products. The Company's plan to address these adverse conditions is to raise additional funds for operations through the issuance of equity securities and debt. These activities are expensive, time-consuming, and uncertain, and any delay could have a material adverse effect on the Company. The accompanying consolidated financial statements do not include any adjustments that may be needed if the Company were unable to continue as a going concern.

In February 2017, the Company issued 16,304,348 shares of Class A common stock in connection with a public offering on the Australian Stock Exchange or ASX. The Company raised a total of $34,110,563, net of issuance costs of $1,364,423. The Company believes that the cash from the offering and its cash and cash equivalents are sufficient to remain in operations for at least one year from December 31, 2016.

## NOTE 3 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (US GAAP). The consolidated financial statements include the accounts of AirXpanders, Inc. and its Australian subsidiary. Intercompany transactions and balances have been eliminated in consolidation. Certain amounts presented in prior periods have been reclassified to the current year presentation. Such changes had no effect on the previously reported net loss or accumulated deficit.

Foreign Currency

The Company transacts business in Australia. The functional currency of its foreign subsidiary is the U.S. dollar. Monetary assets and liabilities are translated at the year-end exchange rate and non-monetary assets and liabilities are translated at historical rates and items in the statement of operations are translated at average rates with gains and losses from remeasurement being recorded in other expense (income), net in the accompanying consolidated statements of operations and comprehensive loss. Foreign currency translation and remeasurement gains or losses included in other expense (income), net in the accompanying consolidated statements of operations and comprehensive loss was a loss of $37,810 during the year ended December 31, 2016 and a gain of $261,478 during the year ended December 31, 2015.

Use of Estimates

The preparation of consolidated financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of expenses during the reporting period. Actual results could differ materially from those estimates. The Company’s most significant estimates relate to the valuation of its common stock prior to the IPO, valuation of stock options and valuation of its inventory at the lower of cost or market.

Certain Significant Risks and Uncertainties

The Company operates in a dynamic, highly competitive industry and believes that changes in any of the following areas could have a material adverse effect on the Company's future financial position, results of operations, or cash flows: ability to obtain future financing; advances and trends in new technologies and industry standards; regulatory approval and market acceptance of the Company's products; development of sales channels; certain supplier relationships; litigation or claims against the Company based on intellectual property, patent, product, regulatory, or other factors including the Company's ability to attract and retain employees necessary to support its growth.

Concentrations of Credit Risk

Financial instruments that potentially subject the Company to credit risk consist primarily of cash and cash equivalents. The Company maintains all of its U.S. cash balances at one financial institution, which at times may exceed the Federal Deposit Insurance Corporation

## NOTE 3 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

(FDIC) limits of $250,000 for interest-bearing accounts. At December 31, 2016, the Company had unrestricted cash balances of approximately $10,822,486 that were in excess of the FDIC limits. The Company also maintains all of its Australian cash balance at one financial institution, which at times may exceed the Australian government guaranteed limit of USD $180,777 (AU$ 250,000). At December 31, 2016, the Company had a cash balance of approximately $798,527 that were in excess of the guaranteed limit.

Cash and Cash Equivalents
The Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents. At December 31, 2016, the Company maintained a balance of $10,501,867 with one U.S. financial institution and the US dollar equivalent of approximately $975,284 with one Australian financial institution.

Inventory
Inventory is valued at the lower of cost or market value, with cost determined by the first-in, first-out method. When needed, the Company provides reserves for excess or obsolete inventory.

Property and Equipment
Property and equipment are stated at cost, net of accumulated depreciation and amortization. Depreciation and amortization is computed using the straight-line method over the estimated useful lives of the assets, generally three to five years. Leasehold improvements and property and equipment under capital leases are amortized over the shorter of the estimated useful lives of the assets or the lease terms. Construction in process assets are stated at cost and will be depreciated over their estimated useful lives once placed in service.

Expenditures for repairs and maintenance are charged to expense as incurred. Upon disposition of an asset, the cost and related accumulated depreciation are removed from the accounts and the resulting gain or loss is reflected in the statement of operations.

Impairment of Long-Lived Assets
The Company's long-lived assets and other assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. Recoverability of an asset to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the asset. If such asset is considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the asset exceeds its fair value. Through December 31, 2016, the Company had not experienced impairment losses on its long-lived assets.

Fair Value of Financial Instruments
The Company follows Financial Accounting Standards Board ("FASB") Accounting Standards Codification Topic No. 820, Fair Value Measurement ("ASC 820"), which clarifies fair value as an exit price, establishes a hierarchal disclosure framework for measuring fair value, and

## NOTE 3 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

requires extended disclosures about fair value measurements. The provisions of ASC 820 apply to all financial assets and liabilities measured at fair value.

As defined in ASC 820, fair value represents the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As a result, fair value is a market-based approach that should be determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering these assumptions, ASC 820 defines a three-tier value hierarchy that prioritizes the inputs used in the valuation methodologies in measuring fair value.

Fair Value of Financial Instruments (continued)

Level 1 – Quoted prices in active markets for identical assets or liabilities.

Level 2 – Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 – Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The following table sets forth by level, within the fair value hierarchy, the Company's assets measured at fair value in the balance sheet as of December 31, 2016:

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Cash and cash equivalents | $ 11,477,151 | $ - | $ - | $ 11,477,151 |
| **Total assets at fair value** | **$ 11,477,151** | **$ -** | **$ -** | **$ 11,477,151** |

The following table sets forth by level, within the fair value hierarchy, the Company's assets measured at fair value in the balance sheet as of December 31, 2015:

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Cash and cash equivalents | $ 19,112,802 | $ - | $ - | $ 19,112,802 |
| **Total assets at fair value** | **$ 19,112,802** | **$ -** | **$ -** | **$ 19,112,802** |

## NOTE 3 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

As of December 31, 2016 and 2015, the Company had the following financial instruments for which disclosure only of fair value is required:

Long-term debt
Long-term debt is valued at carrying value which is considered to be representative of its fair value based on current market rates available to the Company for comparable borrowing facilities as well as due to its short time of maturity (Level 2 measurement).

Revenue Recognition
The Company recognizes revenue from sales of its products in accordance with the Revenue Recognition Topic ASC 605. The Company recognizes revenue from product sales when the following four criteria are met: delivery has occurred, there is persuasive evidence of an arrangement, the fee is fixed or determinable, and collectability of the related receivable is reasonably assured. Revenue recognition generally occurs after a device has been implanted in a patient and a purchase order has been received from the customer.

Accounts Receivable and Allowance for Doubtful Accounts
Accounts receivable are stated at cost, net of allowance for doubtful accounts. Credit is extended to customers based on an evaluation of their financial condition and other factors. The Company does not charge interest on past due balances. The Company generally does not require collateral or other security to support accounts receivable. The Company performs ongoing credit evaluations of its customers and maintains an allowance for doubtful accounts.

The Company estimates its allowance for doubtful accounts by evaluating specific accounts where information indicates that customers may have an inability to meet their financial obligations and receivable amounts are outstanding for an extended period beyond the invoice terms. In these cases, the Company uses assumptions and judgment, based on the best available facts and circumstances, to either record a specific allowance against these customer balances or to write the balances off. The accounts receivable aging is reviewed on a regular basis and write-offs are recorded on a case-by-case basis net of any amounts that may be collected. Allowance charges are recorded as operating expenses. Based on the Company's customer analysis, it did not have an allowance for doubtful accounts at December 31, 2016 and 2015.

Concentration
Two customers each contributed 16% of the Company's revenue for the year ended December 31, 2016 and two customers accounted for 33%, respectively, of the accounts receivable balance at December 31, 2016. One customer contributed 24% of the Company's revenue for the year ended December 31, 2015 and two customers accounted for 47% of the accounts receivable balance at December 31, 2015. Substantially all product sales in 2016 and 2015 were to hospitals in Australia.

## NOTE 3 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Reverse Stock Split

In May 2015 the Company's shareholders approved a 5-for-1 reverse stock split of all outstanding common stock and all securities exercisable into common stock. All amounts for common stock, preferred stock conversion ratios, stock options and warrants in the consolidated financial statements have been retroactively adjusted to reflect the effect of the reverse stock split.

Stock-Based Compensation

Stock-based compensation is measured at the grant date based on the fair value of the award. The fair value of the award that is ultimately expected to vest is recognized as expense on a straight-line basis over the requisite service period, which is generally the vesting period. The expense recognized for the portion of the award that is expected to vest has been reduced by an estimated forfeiture rate. The forfeiture rate is determined at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

The Company uses the Black-Scholes option-pricing model (the "Black-Scholes model") as the method for determining the estimated fair value of stock options.

*Expected Term*

The Company's expected term represents the period that the Company's stock-based awards are expected to be outstanding and is determined using the simplified method, which essentially equates to a weighted average of the vesting periods and total term of the award.

*Expected Volatility*

Expected volatility is estimated using comparable public company's volatility for similar terms as the Company does not have a long enough operating period as a public company to estimate its own volatility. Over time as the Company develops its own volatility history it will begin to incorporate that history into its expected volatility estimates.

*Expected Dividend*

The Black-Scholes model calls for a single expected dividend yield as an input. The Company has never paid dividends and has no current plans to pay dividends on its common stock.

*Risk-Free Interest Rate*

The risk-free interest rate used in the Black-Scholes model is based on the U.S. Treasury zero coupon issues in effect at the time of grant for periods corresponding with the expected term of the option.

The Company recognizes the fair value of stock options granted to nonemployees as stock-based compensation expense over the period in which the related services are received.

Research and Development

Costs incurred in research and development activities (including clinical trials) are expensed as incurred. Research and development costs include, but are not limited to, payroll and personnel expenses, laboratory supplies, consulting costs, travel, parts and materials, equipment expenses, and equipment depreciation.

## NOTE 3 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Income Taxes

The Company accounts for income taxes using the asset and liability method. Under this method, deferred income tax assets and liabilities are recorded based on the estimated future

tax effects of differences between the financial statement and income tax basis of assets and liabilities. In addition, deferred tax assets are recorded for the future benefit of utilizing net operating loss and tax credit carryovers. Deferred tax assets and liabilities are measured using the enacted tax rates applied to taxable income. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is provided against the Company's deferred income tax assets when it is more likely than not that the asset will not be realized.

Significant judgment is required in determining any valuation allowance recorded against deferred tax assets. In assessing the need for a valuation allowance, the Company considers all available evidence, including past operating results, estimates of future taxable income and the feasibility of tax planning strategies. In the event that the Company changes its determination as to the amount of deferred tax assets that are more likely than not to be realized, the Company will adjust its valuation allowance with a corresponding impact to the provision for income taxes in the period in which such determination is made.

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

Segments

The Company has determined the chief executive officer is the chief operating decision maker. The Company's chief executive officer reviews financial information presented for purposes of assessing performance and making decisions on how to allocate resources. The Company has determined that it operates in a single reporting segment.

Basic and Diluted Net Loss Per Share

Basic net loss per share is computed by dividing the net loss by the weighted-average number of shares of common stock outstanding during the period. Diluted net loss per share is computed by giving effect to all potential shares of common stock, stock options, stock warrants, convertible debt and convertible preferred stock to the extent dilutive. For the periods presented, all such common stock equivalents have been excluded from diluted net loss per share as the effect to net loss per share would be anti-dilutive.

## NOTE 3 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

The following table sets forth the computation of the Company's basic and diluted net loss per share for the years ended December 31, 2016 and 2015:

| | 2016 | 2015 |
|---|---|---|
| Numerator | | |
| Net loss | $(19,422,897) | $(11,161,345) |
| Denominator | | |
| Weighted-average common shares for basic and diluted net loss per share | 74,793,530 | 35,377,588 |
| Basic and diluted net loss per share | $ (0.26) | $ (0.32) |

Following is a table summarizing the potentially dilutive common shares that were excluded from diluted weighted-average common shares outstanding as there effects would be antidilutive as of December 31:

| | 2016 | 2015 |
|---|---|---|
| Shares of common stock issuable upon conversion of warrants and convertible preferred stock | 336,814 | 386,814 |
| Shares of common stock options | 5,355,702 | 5,590,619 |
| Potential common shares excluded from diluted net loss per share | **5,692,516** | **5,977,433** |

Subsequent to December 31, 2016, the Company issued 16,304,348 shares of common stock in connection with a public offering (See Note 16, "Subsequent Events").

Recent Accounting Pronouncements

In November 2016, the FASB issued ASU 2016-18, Statement of Cash Flows (Topic 230): Restricted Cash, which requires that a statement of cash flows explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The new guidance is effective for annual reporting periods beginning after December 15, 2017, and interim periods within that reporting period. Early adoption is permitted including adoption in an interim period. The Company is currently in the process of evaluating the impact of the adoption on its consolidated financial statements and related disclosures.

In August, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments, which addresses certain issues where diversity in practice was identified and may change how an entity classifies certain cash receipts and cash payments on its statement of cash flows. The new guidance is effective for annual reporting periods beginning after December 15, 2017, and interim periods within that reporting period. Early adoption is permitted. The Company is currently in the process of evaluating the impact of the adoption on its consolidated financial statements and related disclosures.

## NOTE 3 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

In March 2016, the FASB issued ASU 2016-09, Improvements to Employee Share-Based Payment Accounting, which amends ASC Topic 718, Compensation—Stock Compensation. The new guidance simplifies several aspects of the accounting for employee share-based payment transactions for both public and nonpublic entities, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. The new guidance is effective for public business entities for annual reporting periods beginning after December 15, 2016, and interim periods within that reporting period. The Company is currently evaluating the impact of this guidance on its consolidated financial statements.

In February 2016, the FASB issued a new standard, Leases, ASC 842. Lessees will need to recognize all lease arrangements with terms longer than twelve months on their balance sheet as a right-of-use asset and a corresponding lease liability. For income statement purposes, the FASB retained a dual model, requiring leases to be classified as either operating or finance. Lessor accounting is similar to the current model. Existing sale-leaseback guidance, including guidance for real estate, is replaced with a new model applicable to both lessees and lessors. The new guidance is effective for public business entities in fiscal years beginning after December 15, 2018. The Company is currently evaluating the impact of this guidance on its consolidated financial statements.

In November, 2015, the FASB issued ASU 2015-17, "Income Taxes". The new guidance requires that all deferred tax assets and liabilities, along with any related valuation allowance for each tax-paying jurisdiction within each tax-paying component, be classified as noncurrent on the balance sheet. The new guidance will be effective for public business entities in fiscal years beginning after December 15, 2016, including interim periods within those years. Early adoption is permitted for all entities as of the beginning of an interim or annual reporting period. The Company adopted the ASU as of December 31, 2016 and its consolidated Balance Sheets as of this date reflects the revised classification of current deferred tax assets and liabilities as noncurrent. However, due to 100% valuation allowance against the Company's net deferred tax assets adoption had substantially no impact on its consolidated financial statements.

In July 2015, the FASB issued ASU 2015-11, "Inventory (Topic 330): Simplifying the Measurement of Inventory". ASU 2015-11 more closely aligns the measurement of inventory in U.S. GAAP with the measurement of inventory in International Financial Reporting Standards by requiring companies using any methods of inventory valuation other than last-in, first-out or the retail inventory methods to measure inventory using the lower of cost and net realizable value, where net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. For public business entities, ASU 2015-11 is effective for annual reporting periods beginning after December 15, 2016 including interim periods within those fiscal years. ASU 2015-11 should be applied prospectively with earlier application permitted as of the beginning of an interim or annual reporting period. The Company is currently evaluating the impact of this ASU in its consolidated financial statements.

In April 2015, the FASB issued ASU 2015-03, "Simplifying the Presentation of Debt Issuance Costs", which requires that debt issuance costs related to a recognized debt liability be presented

**NOTE 3 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. This ASU requires retrospective adoption and is effective in 2016 for the Company. The Company adopted this ASU as required on a retrospective basis which resulted in an immaterial debt issuance cost reclassification as of December 31, 2016 and 2015 in its consolidated financial statements.

In August 2014, the FASB issued ASU 2014-15, "Presentation of Financial Statements - Going Concern" relating to the disclosure of an entity's going concern uncertainty. This update provides guidance about managements responsibilities in evaluating an entity's going concern uncertainties, and about the timing and content of related footnote disclosures. Under this amended guidance, an entity's management should evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date the consolidated financial statements are issued. For public business entities, ASU 2014-15 is effective for annual reporting periods ending after December 15, 2016. The Company adopted this ASU as required for its December 31, 2016 consolidated financial statements and made the required evaluation and disclosures.

In May 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers (Topic 606)". The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity should 1) identify the contract(s) with a customer, 2) identify the performance obligations in the contract, 3) determine the transaction price, 4) allocate the transaction price to the performance obligations in the contract, and 5) recognize revenue when (or as) the entity satisfies a performance obligation. In July 2015, the FASB deferred for one year the effective date of the new revenue standard, but early adoption will be permitted. The new standard will be effective for the Company on January 1, 2018. The Company is currently evaluating the impact of this ASU on its consolidated financial statements.

**NOTE 4 – INVENTORY**

Inventory consisted of the following as of December 31:

| | 2016 | 2015 |
|---|---|---|
| Raw materials | $ 760,317 | $ 220,667 |
| Work in progress | 438,669 | 241,949 |
| Finished goods | 214,114 | 64,404 |
| **Inventory** | **$ 1,413,100** | **$ 527,020** |

The Company had written down its inventory to market value by $1,537,090 and $527,444 for the years ended December 31, 2016 and 2015, respectively.

## NOTE 5 – PROPERTY AND EQUIPMENT

Property and equipment consists of the following as of December 31:

| | 2016 | 2015 |
|---|---|---|
| Machinery and equipment | $ 1,084,549 | $ 714,382 |
| Computer equipment | 160,956 | 121,926 |
| Furniture and fixtures | 83,870 | 77,457 |
| Leasehold improvements | 170,241 | 100,354 |
| Software licenses | 189,216 | 19,061 |
| Office equipment | 10,692 | 8,679 |
| Construction in progress | 872,032 | 395,903 |
| Property and equipment, gross | 2,571,556 | 1,437,762 |
| Accumulated depreciation and amortization | (692,268) | (528,100) |
| **Property and equipment, net** | **$ 1,879,288** | **$ 909,662** |

Depreciation and amortization expense amounted to $237,291 and $85,619 for the years ended December 31, 2016 and 2015, respectively.

## NOTE 6 – ACCRUED EXPENSES

Accrued expenses consisted of the following as of December 31:

| | 2016 | 2015 |
|---|---|---|
| Accrued compensation and benefits | $ 424,899 | $ 199,290 |
| Accrued rent payable | 68,908 | 28,976 |
| Accrued clinical trials services | 176,975 | - |
| Accrue inventory supplies | 92,617 | 42,735 |
| Accrued other | 152,148 | 122,958 |
| **Total accrued expenses** | **$ 915,547** | **$ 393,959** |

## NOTE 7 – DEBT FINANCING

**Loans**

In January 2014, the Company borrowed $3,500,000 under a loan and security agreement with a financial institution which expires in July 2017. Interest is paid monthly on the principal amount at 7.34% per annum. The loan is secured by substantially all of the Company's assets, excluding intellectual property. Under the terms of the agreement, interest-only payments were made monthly through March 2015, with principal payments commencing in April 2015, due in 28 equal monthly installments. A fee of $271,250 is due at maturity, which is being accrued over the term of the loan. The Company can prepay the entire loan amount by providing a written five day notice prior to such prepayment and pay all outstanding principal, interest and

**NOTE 7 – DEBT FINANCING (continued)**

prepayment fees plus any default fees and all other sums that shall have become due and payable

In March 2015, the Company amended the loan and security agreement to extend the interest-only period from March 2015 to April 2015, with principal payments commencing in May 2015, due in 27 equal monthly installments. The Company had the option to borrow an additional $3,500,000 under the agreement, with the same terms, if certain conditions were met. This option expired unexercised in June 2015.

In connection with the loan agreement and security agreement, the Company granted a warrant to the financial institution for the purchase of 52,500 shares of Series E convertible preferred stock ("Series E") at $1.00 per share. As a result of the Company's IPO in June 2015 and conversion of all outstanding preferred stock into common stock, the warrants were converted into warrants for 52,500 shares of common stock at an exercise price of $1.00 per share. The fair value of the warrant of $31,710 on the date of issuance was recorded as a debt discount.

The Company recorded $34,814 and $36,566 to interest expense related to amortization of the debt discount and issuance costs for the years ended December 31, 2016 and 2015 respectively. As of December 31, 2016, the unamortized discount and issuance cost is $31,240.

The Company recorded $249,054 and $346,251 of interest expense on the loans for the years ended December 31, 2016 and 2015, respectively. At December 31, 2016, $1,226,574 was outstanding under this loan and security agreement.

**Convertible Bridge Notes Payable**

In February and June 2015, the Company raised through a private placement of convertible bridge notes payable a total of $4,959,987 in net cash proceeds. The convertible bridge notes had a stated interest rate of 7% per annum. All the outstanding convertible bridge notes payable and accrued unpaid interest of $70,233 were converted into 4,412,474 shares of common stock as part of Company's IPO in June 2015.

Lease Obligations

The Company leases its office space under a non-cancelable operating lease. Monthly base rent payments range from approximately $13,300 to $21,300. In July 2015, the Company signed an agreement to extend its current office space lease to September 30, 2019. Under the same lease agreement, the Company expanded the premises and leased additional office space commencing October 1, 2015.

The Company recognizes rent expense on a straight-line basis over the term of the lease. Rent expense (including common area maintenance) related to the Company's operating leases was $513,794 and $272,967 for the years ended December 31, 2016 and 2015, respectively. The deferred rent balance was $68,908 and $28,976 at December 31, 2016 and 2015, respectively.

## NOTE 8 – COMMITMENTS

As of December 31, 2016, the future rental commitments due under the lease are:

| Years Ending December 31, | |
|---|---|
| 2017 | $ 401,842 |
| 2018 | 413,898 |
| 2019 | 317,356 |
| **Total** | **$ 1,133,096** |

Indemnifications

The Company has agreed to indemnify its officers and directors for certain events or occurrences arising as a result of the officers or directors serving in such capacity. The Company has a directors and officers' liability insurance policy that limits its exposure and enables the Company to recover a portion of any future amounts paid resulting from the indemnification of its officers and directors. In addition, the Company enters into indemnification agreements with other parties in the ordinary course of business. The Company has not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. The Company's management believes the estimated fair value of these indemnification agreements is minimal and has not recorded a liability for these agreements as of December 31, 2016 and 2015.

Royalties

The Company uses AeroForm® technology in the products it is developing. AeroForm® embodies inventions that have been patented in certain key jurisdictions. Certain of those patents are held by Shalon Ventures (either alone or jointly with AirXpanders). Shalon Ventures and AirXpanders have entered into a License Agreement dated March 9, 2005 (as amended on March 9, 2009 and January 9, 2012) in relation to those inventions (Shalon Ventures License Agreement). Pursuant to the Shalon Ventures License Agreement, Shalon Ventures granted AirXpanders an exclusive license to develop, make, have made, use, offer for sale, sell, have sold, import and export products that, but for the license, would infringe one or more claims of the patents. The license covers all human uses of self-expanding tissue expanders anywhere in the world and includes the right to sublicense.

In consideration for the license, AirXpanders pays Shalon Ventures a running royalty of 3% of net sales of the licensed invention. If the amount of royalties paid in a calendar year is less than $10,000, then AirXpanders shall also pay Shalon Ventures' out of pocket costs for prosecuting and maintaining the relevant patents. Each party indemnifies the other for any liability arising out of its material breach of the license, or its gross negligence, intentional misconduct and illegal actions. AirXpanders also indemnifies Shalon Ventures for any liability arising out of the commercialization of products using the license. Through the year ended December 31, 2016, the Company has incurred $19,266 in royalty fees. Mr. Teddy Shalon and Mr. Barry Cheskin are directors and shareholders of the Company. Mr. Cheskin is also the co-founder and chairman of the board of the Company. Mr. Shalon is the

## NOTE 8 – COMMITMENTS (continued)

Chief Executive Officer and sole shareholder of Shalon Ventures. Mr. Shalon and Mr. Cheskin are each party to an agreement with Shalon Ventures, under which Shalon Ventures has agreed to pay Mr. Shalon 58%, and Mr. Cheskin 8%, of any royalties due to Shalon Ventures from AirXpanders under the Shalon Ventures License Agreement.

## NOTE 9 – COMMON STOCK

In May 2015, the Company's shareholders approved a 5-for-1 reverse stock split of all outstanding common stock and all securities exercisable into common stock.

The Company's Articles of Incorporation, as amended, authorize the Company to issue 300,000,000 shares of $0.001 par value common stock consisting of 200,000,000 shares of common stock Class A and 100,000,000 shares of common stock Class B. Class A common stockholders are entitled to dividends when and if declared by the Board of Directors, Class B common stockholders are not entitled to any dividends. The holder of each share of Class A common stock is entitled to one vote and holders of Class B common stock are not entitled to vote. At December 31, 2016 and 2015, no dividends had been declared for common stock. At December 31, 2016, 79,241,708 and no shares of common stock Class A and Class B respectively, were issued and outstanding.

As of December 31, 2016 and 2015, common stock that the Company had reserved for issuance was as follows:

| | 2016 | 2015 |
|---|---|---|
| Warrants for common and convertible preferred shares | 336,814 | 386,814 |
| Stock option plans | 6,956,580 | 5,590,619 |
| **Total** | **7,293,394** | **5,977,433** |

In June 2016, the Company issued 8,771,930 shares of common stock in connection with a Secondary Offering on the ASX. The Company cash proceeds were $14,158,511, net of issuance costs of $731,489.

In June 2015, the Company issued 29,629,654 shares of common stock in connection with an IPO on the ASX and conversion of convertible bridge notes payable and related accrued interest. The Company raised a total of $30,089,162, net of issuance costs of $2,872,649. Of this amount $28,001,824 (AU$36.5 million) were cash proceeds directly from the IPO; $4,959,987 were cash proceeds from the private placement of convertible bridge notes payable.

## NOTE 10 – CONVERTIBLE PREFERRED STOCK

The Company issued Series A, B, B-1, C, D and E convertible preferred stock during the period from 2005 through 2014, raising a total of $30,393,627 in cash, net of issuance costs of $595,493.

As part of Company's IPO in June 2015, all outstanding convertible preferred stock was converted into common stock. Series A, B, B-1 and E convertible preferred stock were converted to common stock at a 1:1 ratio, Series C convertible preferred stock was converted to common at a 1.25:1 ratio and Series D convertible preferred stock was converted to common at a 1.35:1 ratio. After conversion of all preferred stock to common stock, the Company cancelled all existing series of preferred stock.

The Company's Articles of Incorporation, as amended, authorize the Company to issue 10,000,000 authorized shares of preferred stock, with rights and privileges for preferred stock to be determined by Company's Board of Directors before issuing preferred shares. At December 31, 2016, there are no outstanding shares of preferred stock.

## NOTE 11 – STOCK WARRANTS

The Company accounts for warrants in accordance with ASC 480, "*Distinguishing Liabilities from Equity*" ("ASC 480"). Under ASC 480, warrants containing certain features, such as put rights and anti-dilution protection, are required to be accounted for as liabilities and recorded at fair value, with changes in fair value being recorded in the statement of operations. The Company's preferred stock warrants prior to conversion to common stock warrants had contained such features, requiring liability accounting.

As part of Company's IPO in June 2015, all outstanding preferred stock warrants were converted into warrants for common stock. As a result of this conversion, the warrants liabilities for $122,516 were reclassified to additional paid in capital. The Company is required to reserve authorized but unissued shares of its common stock in an amount equal to the number of warrant shares purchasable under the arrangements described below.

The warrant liabilities were revalued at the end of each reporting period and through June 2015 the date of conversion to common stock warrants with the changes in fair value recorded in other income (expense) in the statements of operations.

The changes in fair value of these warrants recorded as other income (expense) for the year ended December 31, 2015 totaled ($41,623).

## NOTE 11 – STOCK WARRANTS (continued)

The fair value of the warrant liabilities was estimated using Black-Scholes model using the following assumptions for 2015 at the date of conversion:

| | |
|---|---|
| Stock price | $1.16 |
| Expected term (years) | 0.62 – 8.67 years |
| Volatility | 33.06 – 43.08% |
| Risk-free interest rate | 0.24 – 1.99% |
| Dividend yield | 0% |

The Company's outstanding warrants consisted of the following as of December 31:

| | 2016 | 2015 |
|---|---|---|
| Warrants; exercisable in common stock, exercise price $2.381 per share, expired in March 2016 | - | 50,000 |
| Warrants; exercisable in common stock, exercise price $0.05 per share, expiring in June 2018 | 119,314 | 119,314 |
| Warrants; exercisable in common stock, exercise price $0.05 per share, expiring in October 2018 | 5,000 | 5,000 |
| Warrants; exercisable in common stock, exercise price $1.25 per share, expiring in February 2021 | 120,000 | 120,000 |
| Warrants; exercisable in common stock, exercise price $1.00 per share, expiring in January 2023 | 40,000 | 40,000 |
| Warrants; exercisable in common stock, exercise price $1.00 per share, expiring in January 2024 | 52,500 | 52,500 |
| **Total** | **336,814** | **386,814** |

## NOTE 12 – STOCK-BASED COMPENSATION

In March 2005, the Company adopted the 2005 Equity Incentive Plan (the "2005 Plan"). In May 2015 the Company adopted the 2015 Equity Incentive Plan (the "2015 Plan") collectively, (the "Plans"). The Plans provide for the granting of stock options to employees and consultants of the Company. Options granted under the Plan may be either incentive stock options or nonqualified stock options. Incentive stock options (ISO) may be granted only to Company employees (including officers and directors who are also employees). Nonqualified stock options (NSO) may be granted to Company employees and consultants.

In May 2013, the 2005 Plan was amended to increase the number of shares reserved for issuance under the Plan to 6,170,159 shares of common stock.

During the year ended December 31, 2015, the 2005 Plan expired and no future options can be granted under the 2005 Plan.

The Company has reserved 1,500,000 shares under the 2015 Plan in addition a total of 4,099,835 shares reserved under the 2005 Plan will be added to 2015 plan if and when the underlying options are cancelled.

## NOTE 12 – STOCK-BASED COMPENSATION (continued)

Options under the Plans may be granted for periods of up to 10 years and at prices no less than 100% of the estimated fair value of the shares on the date of grant. In the case of an Incentive Stock Option granted to a holder who, at the time the Option is granted, owns stock representing more than 10% of the voting power of all classes of stock of the Company, the term of the Option shall be up to 5 years from the date of grant and at no less than 110% of the estimated fair value of the shares on the date of grant. Options granted generally vest 1/4 on the 12-month anniversary of the vesting commencement date and 1/48 on each monthly anniversary thereafter.

At December 31, 2016 and 2015, 5,216,327 and 4,127,900 options were vested and expected to vest with a weighted-average exercise price of $0.3775 and $0.3329 and weighted average remaining contractual life of 6.60 and 6.57 years, respectively. The weighted average grant date fair value per share of options granted during the years ended December 31, 2016 and 2015 was $0.8553 and $0.3439, respectively. The fair value of shares vested during the years ended December 31, 2016 and 2015 was $226,611 and $96,344, respectively. The weighted average exercise price of options exercised during the year ended December 31, 2016 and 2015 was $0.25 and $0.18, respectively. The intrinsic value of the options exercised during the year ended December 31, 2016 and 2015 was $98,407 and $5,343, respectively.

In connection with the grant of stock options to employees and non-employees, the Company recorded stock compensation expense as follows:

| | December 31 2016 | December 31 2015 |
|---|---|---|
| Cost of goods sold | $ 44,446 | $ - |
| Research and development | 32,448 | - |
| Selling, general and administrative | 300,478 | 111,503 |
| **Total** | $ **377,372** | **$ 111,503** |

As of December 31, 2016, unrecognized compensation expense related to employees and to non-employees totaled $989,480 and $94,974, respectively, and will be recognized over approximately 3.1 years and 2.4 years, respectively.

## NOTE 12 – STOCK-BASED COMPENSATION (continued)

Activity under the Plan is set forth below:

| | Options Available for Grant | Number of Options Outstanding | | Weighted Average Exercise Price per Share | Weighted Average Remaining Contractual Life in Years |
|---|---|---|---|---|---|
| **Balance – December 31, 2014** | **1,516,823** | **3,845,709** | **$** | **0.30** | **7.33** |
| Additional shares reserved (net of released) | 231,052 | - | $ | - | - |
| Options granted | (357,127) | 357,127 | $ | 0.90 | - |
| Options exercised | - | (2,965) | $ | 0.18 | - |
| Options forfeited/cancelled | 28,579 | (28,579) | $ | 0.96 | - |
| **Balance – December 31, 2015** | **1,419,327** | **4,171,292** | **$** | **0.33** | **6.57** |
| Additional shares reserved (net of released) | 1,408,544 | - | $ | - | - |
| Options granted | (1,531,169) | 1,531,169 | $ | 2.44 | - |
| Options exercised | - | (42,583) | $ | 0.25 | - |
| Options forfeited/cancelled | 304,176 | (304,176) | $ | 0.60 | - |
| **Balance December 31, 2016** | **1,600,878** | **5,355,702** | **$** | **$0.92** | **6.60** |

The fair value of options granted to employees was estimated at the date of grant using the following assumptions for the years ended December 31:

| | 2016 | 2015 |
|---|---|---|
| Expected term (years) | 5.54 – 6.08 years | 5.83 – 6.58 years |
| Volatility | 33.73 – 34.87% | 34.91 – 43.52% |
| Risk-free interest rate | 1.18 – 1.86% | 1.44 – 1.85% |
| Dividend yield | - % | - % |

## NOTE 13 – INCOME TAXES

The Company had an effective tax rate of 0.0%, and 0.0% for the years ended December 31, 2016, and 2015, respectively.

Reconciliations of the provision for income taxes at the statutory rate to the Company's provision for income tax is as follows:

| | December 31, 2016 | December 31, 2015 |
|---|---|---|
| U.S. Federal (tax benefit) provision at statutory rate | $ (6,603,513) | $ (3,794,585) |
| State (tax benefit) income taxes, net of federal benefit | - | (83,088) |
| Stock-based compensation | 52,898 | 27,101 |
| Change in valuation allowance | 6,813,191 | 4,063,669 |
| Research and development credits | (276,664) | (223,914) |
| Others permanent differences | 14,088 | 10,817 |
| **Total** | **$ -** | **$ -** |

The significant components of the net deferred tax asset are as follows:

| | December 31, 2016 | December 31, 2015 |
|---|---|---|
| Gross deferred income tax assets | | |
| Net operating loss carryforwards | $ 23,640,605 | $ 17,561,629 |
| R&D credits | 1,053,563 | 801,566 |
| Property and equipment (depreciation) | (45,884) | (75,493) |
| Others | 1,410,946 | 420,459 |
| Total deferred tax assets | 26,059,230 | 18,708,161 |
| Valuation allowance | (26,059,230) | (18,708,161) |
| **Total** | **$ -** | **$ -** |

A valuation allowance has been recorded for the entire amount of the Company's deferred tax assets as a result of uncertainties regarding the realization of the deferred tax assets. The change in the valuation allowance totaled $7,351,069 and $4,033,342 for the years ended December 31, 2016 and 2015, respectively, principally due to increases in the valuation allowance associated with increased net operating losses.

As of December 31, 2016, the Company had net operating loss carryforwards for federal and state income tax reporting purposes of approximately $63,168,055 and $37,081,213 respectively. As of December 31, 2016, the Company also had Federal and California research and development tax credit carryforwards of approximately $662,756 and $592,132 respectively. The Federal net operating loss and tax credit carryforwards will expire at various dates beginning in 2025 through 2036. The California net operating loss carryforwards will

**NOTE 13 – INCOME TAXES (continued)**

expire at various dates beginning in 2017 through 2036. The California research and development tax credit carryforwards have no expiration date.

Utilization of the NOL and tax credit carryforwards may be subject to a substantial annual limitation due to ownership change limitations that may have occurred or that could occur in the future, as required by the Internal Revenue Code (the "Code"), as well as similar state provisions. In general, an "ownership change" as defined by the Code results from a transaction or series of transactions over a three-year period resulting in an ownership change of more than 50 percentage points of the outstanding stock of a company by certain stockholders or public groups.

Since the Company's formation, the Company has raised capital through the issuance of capital stock on several occasions which, combined with the purchasing stockholders' subsequent disposition of those shares, may have resulted in such an ownership change, or could result in an ownership change in the future upon subsequent disposition. The annual limitation may result in the expiration of NOL and tax credit carryforwards before utilization.

The Company has not completed a study to assess whether an ownership change has occurred or whether there have been multiple ownership changes since the Company's formation due to the complexity and cost associated with such a study, and the fact that there may be additional such ownership changes in the future. If the Company has experienced an ownership change at any time since its formation, utilization of the NOL or tax credit carryforwards to offset future taxable income and taxes, respectively, would be subject to an annual limitation under the Code, which is determined by first multiplying the value of the Company's stock at the time of the ownership change by the applicable long-term, tax-exempt rate, and then could be subject to additional adjustments, as required. Any limitation may result in expiration of all or a portion of the NOL or tax credit carryforwards before utilization.

The Company maintains a full valuation allowance for its deferred tax assets due to its historical losses and uncertainties surrounding its ability to generate future taxable income to realize these assets. Due to the existence of the valuation allowance, future changes in any unrecognized tax benefits and recognizable deferred tax benefits after the completion of an ownership change analysis is not expected to impact its effective tax rate.

The following table displays by contributing factor the changes in the valuation allowance for deferred tax assets since:

| | December 31, 2016 | December 31, 2015 |
|---|---|---|
| Balance at the beginning of the period | $ 18,708,161 | $ 14,674,819 |
| Net operating loss generated | 6,078,975 | 3,592,882 |
| R&D tax credit increase | 251,998 | 211,630 |
| Depreciation and amortization increase (decrease) | 29,608 | (44,346) |
| Reserves and accruals increase | 990,487 | 273,176 |
| **Balance at the end of the period** | **$ 26,059,229** | **$ 18,708,161** |

## NOTE 13 – INCOME TAXES (continued)

The following table reflects changes in the unrecognized tax benefits since January 1, 2015:

| | December 31, 2016 | December 31, 2015 |
|---|---|---|
| Gross amount of unrecognized tax benefits as of the beginning of the period | $ 799,815 | $ - |
| Increase related to current year tax provision | 743,908 | - |
| **Gross amount of unrecognized tax benefits as of the end of the period** | **$ 1,543,723** | **$ -** |

The Company files income tax returns in the United States on federal basis and various states. The Company is not currently under any international or any United States federal, state and local income tax examinations for any taxable years. A number of the Company's tax returns remain subject to examination by taxing authorities: these include U.S. federal and state tax returns from 2012 forward.

## NOTE 14 – RETIREMENT PLAN

The Company has a salary deferral plan under Section 401(k) of the Internal Revenue Code. The plan allows eligible employees to defer a portion of their compensation ranging from 1% to the maximum allowable dollar limit which is set by law. Such deferrals accumulate on a tax deferred basis until the employee withdraws the funds. The Company, at its option, may match a portion of the employees' contribution. During the years ended December 31, 2016 and 2015, the Company made no matching contributions.

## NOTE 15 – MANAGEMENT INCENTIVE PLAN

On May 30, 2013, the Company adopted a management incentive plan that establishes a bonus pool with the objective of retaining its key employees and service providers through a potential Corporate Transaction, as defined in the plan. The plan provides for up to 7% of the total proceeds in a Corporate Transaction to be paid to key employees covered under the Plan. The plan was terminated in June 2015 as of the Company's IPO and as a result no amounts were paid under the plan.

## NOTE 16 – SUBSEQUENT EVENTS

In February 2017, the Company issued 16,304,348 shares of common stock in connection with a public offering on the ASX. The Company raised a total of $34,110,563, net of issuance costs of $1,364,423.

The Company has performed an evaluation of subsequent events through February 27, 2017 which is the date these consolidated financial statements were issued.