

EcoSynthetix Inc.

Consolidated Financial Statements
December 31, 2017 and December 31, 2016
(expressed in US dollars)



March 2, 2018

Independent Auditor's Report

To the Shareholders of EcoSynthetix Inc.

We have audited the accompanying consolidated financial statements of EcoSynthetix Inc. and its subsidiaries, which comprise the consolidated balance sheets as at December 31, 2017 and December 31, 2016 and the consolidated statements of operations and comprehensive loss, shareholders' equity and cash flows for the years then ended, and the related notes, which comprise 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.

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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 EcoSynthetix Inc. and its subsidiaries as at December 31, 2017 and December 31, 2016 and their financial performance and their cash flows for the years then ended in accordance with International Financial Reporting Standards.

PricewaterhouseCoopers LLP

Chartered Professional Accountants, Licensed Public Accountants

EcoSynthetix Inc.
Consolidated Balance Sheets
At December 31

(expressed in US dollars)

	2017	2016
Assets		
Current assets		
Cash	19,116,828	38,517,278
Term deposits (note 5)	30,171,121	-
Accounts receivable (note 6)	2,296,255	2,199,289
Inventory (note 7)	2,535,234	3,216,016
Government grants receivable (note 8)	-	168,562
Prepaid expenses	153,524	165,352
	<u>54,272,962</u>	<u>44,266,497</u>
Non-current assets		
Term deposits (note 5)	-	15,043,557
Property, plant and equipment (note 9)	7,115,672	7,933,584
	<u>7,115,672</u>	<u>7,933,584</u>
Total assets	<u>61,388,634</u>	<u>67,243,638</u>
Liabilities		
Current liabilities		
Trade accounts payable and accrued liabilities (note 10)	2,951,220	3,070,203
Accrued termination benefits	39,830	415,888
	<u>2,991,050</u>	<u>3,486,091</u>
Total liabilities	<u>2,991,050</u>	<u>3,486,091</u>
Shareholders' Equity		
Common shares (note 13)	493,631,495	493,359,612
Contributed surplus	9,550,445	8,740,007
Accumulated deficit	<u>(444,784,356)</u>	<u>(438,342,072)</u>
Total shareholders' equity	<u>58,397,584</u>	<u>63,757,547</u>
Total liabilities and shareholders' equity	<u>61,388,634</u>	<u>67,243,638</u>

Approved by the Board of Directors

(signed)

Paul Lucas, Chairman

(signed)

Jeff MacDonald, Chief Executive Officer

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

EcoSynthetix Inc.

Consolidated Statements of Operations and Comprehensive Loss For the years ended December 31

(expressed in US dollars)

	2017	2016
Net sales	17,885,423	13,277,386
Cost of sales	14,215,080	11,076,583
Gross profit on sales	3,670,343	2,200,803
Expenses		
Selling, general and administrative	6,004,556	6,532,524
Research and development	4,711,913	4,941,081
Provision for termination benefits	63,485	534,114
	10,779,954	12,007,719
Loss from operations	(7,109,611)	(9,806,916)
Interest income	667,327	502,318
Net loss and comprehensive loss	(6,442,284)	(9,304,598)
Basic and diluted loss per common share (note 18)	(0.11)	(0.16)
Weighted average number of common shares outstanding	59,551,885	59,307,361

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

EcoSynthetix Inc.

Consolidated Statements of Shareholders' Equity For the years ended December 31

(expressed in US dollars)

	Common shares	Contributed surplus \$	Accumulated deficit \$	Total \$
Balance - January 1, 2016	493,182,209	8,017,907	(429,037,474)	72,162,642
Common share options exercised (note 13)	127,347	(60,109)	-	67,238
Share-based compensation (note 12)	-	832,265	-	832,265
Deferred share unit options exercised	50,056	(50,056)	-	-
Net loss and comprehensive loss	-	-	(9,304,598)	(9,304,598)
Balance - December 31, 2016	493,359,612	8,740,007	(438,342,072)	63,757,547
Common share options exercised (note 13)	81,356	(33,739)	-	47,617
Share-based compensation (note 12)	-	1,034,704	-	1,034,704
Deferred share units	70,642	(70,642)	-	-
Restricted share units	119,885	(119,885)	-	-
Net loss and comprehensive loss	-	-	(6,442,284)	(6,442,284)
Balance - December 31, 2017	493,631,495	9,550,445	(444,784,356)	58,397,584

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

EcoSynthetix Inc.

Consolidated Statements of Cash Flows For the years ended December 31

(expressed in US dollars)

	2017	2016
Cash provided by (used in)		
Operating activities		
Net loss and comprehensive loss	(6,442,284)	(9,304,598)
Items not affecting cash		
Depreciation	1,229,121	1,340,315
Share-based compensation (note 12)	1,034,704	832,265
Unrealized foreign exchange gain	(60,726)	(219)
Other	(234,891)	(228,238)
Changes in non-cash working capital		
Accounts receivable	(96,966)	(1,021,570)
Inventory	629,813	31,168
Government grants receivable (note 8)	-	(670,081)
Prepaid expenses	11,828	77,631
Trade accounts payable and accrued liabilities	(118,983)	1,907,494
Accrued termination benefits	(376,058)	(861,867)
	<u>(4,424,442)</u>	<u>(7,897,700)</u>
Investing activities		
Purchase of property, plant and equipment (note 9)	(360,240)	(584,773)
Purchase of term deposits (note 5)	(15,000,000)	(15,000,000)
	<u>(15,360,240)</u>	<u>(15,584,773)</u>
Financing activities		
Proceeds from government grants	168,562	1,029,955
Exercise of common share options	47,617	67,238
	<u>216,179</u>	<u>1,097,193</u>
Effect of exchange rate changes on cash	<u>168,053</u>	<u>184,900</u>
Decrease in cash during the year	(19,400,450)	(22,200,380)
Cash - Beginning of year	<u>38,517,278</u>	<u>60,717,658</u>
Cash - End of year	<u>19,116,828</u>	<u>38,517,278</u>

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

EcoSynthetix Inc.

Notes to Consolidated Financial Statements

December 31, 2017 and December 31, 2016

(expressed in US dollars, unless otherwise noted)

1 Business operations

EcoSynthetix Inc. (EcoSynthetix or the Company) is engaged in the development and commercialization of environmentally friendly, bio-based technologies as replacement solutions for synthetic, petrochemical-based adhesives and other related products in the Americas, Europe, Middle East and Africa (EMEA) and Asia Pacific. EcoSynthetix is incorporated and domiciled in Canada. The address of its registered office is 3365 Mainway, Burlington, Ontario, Canada.

2 Summary of significant accounting policies

Statement of compliance

These consolidated financial statements have been authorized for issuance by the Board of Directors of the Company on March 2, 2018.

Basis of preparation

The consolidated financial statements have been prepared under International Financial Reporting Standards (IFRS), using the historical cost convention except for liabilities related to share-based payment arrangements that are measured at fair value.

Use of estimates and judgments

The preparation of consolidated financial statements in accordance with IFRS requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. These estimates are based on management's best knowledge of current events and actions that the Company may undertake in the future. Actual results could differ from those estimates.

Significant estimates made by the Company include estimates of useful lives and impairment of property, plant and equipment, share-based compensation, potentially uncollectible accounts receivable, provisions for inventory that are carried in excess of net realizable value and the realizability of deferred income tax assets.

Property, plant and equipment are tested for impairment at the end of each reporting period or when events or changes in circumstances indicate the carrying amounts may not be recoverable. For the purpose of measuring recoverable amounts, assets are grouped at the lowest levels for which there are separately identifiable cash inflows (cash-generating units or CGUs). The recoverable amount is the higher of an asset's fair value less costs to sell and value in use (which is the present value of the expected future cash flows of the relevant asset or CGU). An impairment loss is recognized for the amount by which the asset's carrying amount exceeds its recoverable amount. Non-financial assets that have been impaired previously are reviewed for possible reversal of impairment at each reporting date.

The Company has determined it has a single CGU, assessed as the entity as a whole, due to the interdependence of the Company's assets and liabilities in generating cash inflows. The recoverable amount of the CGU is highly dependent on projected revenues, expenses and discount rates used in performing an analysis.

EcoSynthetix Inc.

Notes to Consolidated Financial Statements

December 31, 2017 and December 31, 2016

(expressed in US dollars, unless otherwise noted)

Basis of consolidation

The consolidated financial statements of the Company consolidate the accounts of EcoSynthetix and all of its subsidiaries. All intercompany transactions, balances and unrealized gains and losses from intercompany transactions are eliminated on consolidation.

Subsidiaries are all entities wholly owned and controlled by the Company.

Foreign currency translation

i) Functional and presentation currency

Items included in the financial statements of each consolidated entity in the Company's consolidated financial statements are measured using the currency of the primary economic environment in which the entity operates (the functional currency). The consolidated financial statements are presented in US dollars, which is the Company's reporting currency. The functional currency of all entities is US dollars.

ii) Transactions and balances

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Foreign currency exchange gains and losses resulting from the settlement of foreign currency transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in currencies other than the Company's functional currency are recognized in the consolidated statements of operations and comprehensive loss.

Cash

Cash consists of deposits held with banks.

Trade receivables

Trade receivables are amounts due from customers for products sold in the ordinary course of business. If collection is expected in one year or less, they are classified as current assets.

Trade receivables are recognized initially at fair value and subsequently measured at amortized cost using the effective interest method, less a provision for impairment.

Financial instruments

Financial assets and financial liabilities are recognized when the Company becomes a party to the contractual provisions of the financial instrument. Financial assets are derecognized when the rights to receive cash flows from the financial assets have expired or have been transferred and the Company has transferred substantially all risks and rewards of ownership.

EcoSynthetix Inc.

Notes to Consolidated Financial Statements

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(expressed in US dollars, unless otherwise noted)

Financial assets and financial liabilities are offset and the net amount reported in the consolidated balance sheets when there is a legally enforceable right to offset the recognized amounts and there is an intention to settle on a net basis, or realize the financial asset and settle the financial liability simultaneously.

At initial recognition, the Company classifies its financial instruments in the following categories, depending on the purpose for which the financial instruments were acquired:

i) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. The Company's loans and receivables comprise accounts receivable, government grants receivable and cash and are classified as current, except for the portion expected to be realized or paid beyond 12 months of the consolidated balance sheet dates, which is classified as non-current. Loans and receivables are initially recognized at the amount expected to be received less, when material, a discount to reduce the loans and receivables to fair value. Subsequently, loans and receivables are measured at amortized cost using the effective interest method, less a provision for impairment.

ii) Financial liabilities at amortized cost

Financial liabilities at amortized cost include trade accounts payable and accrued liabilities. Trade accounts payable and accrued liabilities are initially recognized at the amount required to be paid less, when material, a discount to reduce the payables to fair value. Subsequently, trade accounts payable and accrued liabilities are measured at amortized cost, using the effective interest method.

Financial liabilities are classified as current liabilities if payment is due within 12 months. Otherwise, they are presented as non-current liabilities.

iii) Held-to-maturity

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity dates that the Company has the positive intent and ability to hold to maturity. The Company's held-to-maturity financial instrument consists of term deposits. Subsequent to initial recognition, held-to-maturity investments are measured at amortized cost using the effective interest method less any impairment. Interest is recorded in interest income on the consolidated statements of operations and comprehensive loss.

Impairment of financial assets

At each reporting date, the Company assesses whether there is objective evidence that a financial asset is impaired. If such evidence exists, the Company recognizes an impairment loss on financial assets carried at amortized cost. The loss is the difference between the amortized cost and the present value of the estimated future cash flows, discounted using the financial instrument's original effective interest rate. The carrying amount of the asset is reduced by this amount either directly or indirectly through the use of an allowance account.

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Impairment losses on financial assets carried at amortized cost are reversed in subsequent years if the amount of the loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized.

Inventory

Inventory is valued at the lower of cost, determined on a first-in, first-out basis, and net realizable value. Inventory costs include the costs of material, contract manufacturing costs, variable overhead and an allocation of fixed manufacturing overhead, including depreciation based on normal production volumes. Net realizable value is the estimated selling price less applicable selling expenses.

Property, plant and equipment

Property, plant and equipment are stated at cost less accumulated depreciation and accumulated impairment losses. Cost includes expenditures that are directly attributable to the acquisition of the asset. Subsequent costs are included in the asset's carrying amount or recognized as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Company and the cost can be measured reliably. The carrying amount of a replaced asset is derecognized when replaced. Repairs and maintenance costs are charged to the consolidated statements of operations and comprehensive loss during the year in which they are incurred.

Depreciation is calculated on a straight-line method to reduce the cost of the asset to its residual value over its estimated useful life. The depreciation period applicable to each category of property, plant and equipment is as follows:

Leasehold improvements	remaining lease term
Computer hardware	3 years
Machinery and equipment	2 to 15 years

Useful lives and residual values are reviewed and adjusted, if appropriate, at the end of each reporting period.

An asset's carrying amount is written down immediately to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount. Gains and losses on disposals of property, plant and equipment are determined by comparing the proceeds with the carrying amount of the asset and are included as part of other gains and losses in the consolidated statements of operations and comprehensive loss.

Provisions

Provisions are recognized when the Company has a present legal or constructive obligation as a result of past events, it is more likely than not that an outflow of resources will be required to settle the obligation, and the amount can be reliably estimated. Provisions are measured at management's best estimate of the expenditure required to settle the obligation at the end of the reporting period and are discounted to present value where the effect is material. The Company performs evaluations to identify onerous contracts and, where applicable, records provisions for such contracts.

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Research and product development costs

Expenditures during the research phase are expensed as incurred. Expenditures during the development phase are expensed as incurred, unless it is probable that future economic benefits that are attributable to the asset will flow to the Company and the cost of the asset can be measured reliably. No development costs have been capitalized to date.

Government grants

Government grants include funding for government research and product development support. Research and product development funding is recognized when there is reasonable assurance the Company has complied with the conditions attached to the funding arrangement and is recognized as the applicable costs are incurred. Research and product development funding is presented as a reduction in research and product development expenses, unless it is for the reimbursement of an asset, in which case it is accounted for as a reduction in the carrying amount of the applicable asset.

Revenue recognition

Revenue is recognized when the Company has transferred the significant risks and rewards of ownership of the goods to the buyer, it is probable that the economic benefits will flow to the Company, delivery has occurred, and the amount of revenue and costs incurred or to be incurred can be measured reliably. These criteria are generally met at the time the product is shipped or delivered and the risks and rewards have passed to the customer. Revenue is measured based on the price specified in the sales contract, net of discounts and estimated returns at the time of sale. Historical experience is used to estimate and provide for discounts and returns.

Cost of sales and gross profit

Gross profit is derived from net sales, less cost of sales. Cost of sales includes raw material costs, contract manufacturing costs, freight costs and depreciation related to manufacturing equipment. Raw materials consist of the costs of natural feedstock and process chemicals.

Share capital

Common shares are classified as equity. The Company has classified all outstanding exchangeable shares of its subsidiaries as issued and outstanding of the parent company.

Share-based compensation

The Company operates equity-settled share-based compensation plans under which the Company receives services from employees, advisers, officers, directors, contractors and consultants as consideration for equity instruments (share options, performance-based share options (PSOs), restricted share units (RSUs) and deferred share units (DSUs)) of the Company.

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Each tranche of a share option award is considered a separate award with its own vesting period and recorded at fair value on the date of grant. The fair value of each tranche is measured at the date of grant using the Black-Scholes option pricing model. Compensation expense is recognized over the tranche's vesting period based on the number of awards expected to vest by increasing contributed surplus. The number of awards expected to vest is reviewed periodically with any impact being recognized in the consolidated statements of operations and comprehensive loss. Any contribution paid by an employee or director on the exercise of share options is credited to common shares with any previously recognized compensation expense.

A PSO provides a right, but not an obligation, to purchase common shares of the Company at a stated price for a given period of time. PSOs vest at a rate of 33.33% per year following the grant date subject to the achievement of performance hurdles and can only be settled in common shares issued from treasury. In the event that performance exceeds targeted performance hurdles, vesting can accelerate for PSOs granted; however, in no event can the cumulative vesting exceed 100%. All PSOs have an expiry between seven and ten years from the grant date. The fair values of PSOs are recorded over the expected vesting period, subject to management's estimate of the achievement of the performance hurdles. The fair values of the PSOs are recognized as compensation expense over the vesting period with a corresponding increase to contributed surplus. The exercise price is determined based on the average closing price of common shares on the Toronto Stock Exchange (TSX) five trading days immediately prior to the date as of which fair value is determined. The Company has estimated the length of the expected vesting period at the grant date based on the most likely outcome of the performance conditions. The Company will revise its estimate of the length of the vesting period, if necessary, if subsequent information indicates that the length of the vesting period differs from previous estimates and any change to compensation cost will be recognized in the period in which the revised estimate is made with a corresponding change to contributed surplus. Forfeitures are estimated at the grant date and are revised to reflect a change in expected or actual forfeitures.

The restricted share unit plan (RSU Plan) provides that restricted share unit awards (the RSUAs) may be granted by a committee that administers the RSU Plan to full-time employees, officers and eligible contractors of the Company or an affiliate in a calendar year as a bonus for services rendered to the Company as determined at the sole discretion of the Board. The number of RSUs awarded will be credited to the participants' accounts effective on the grant date of the RSUs. Each RSU entitles the holder to receive common shares issued from the treasury of the Company. RSUs awarded cliff vest at the end of a three-year vesting period subject to continued employment with the Company. Compensation cost is calculated on a straight-line basis over the vesting period with a corresponding increase to contributed surplus. Forfeitures are estimated at the grant date and are revised to reflect a change in expected or actual forfeitures.

The deferred share unit plan (DSU Plan) provides for awards of DSUs to non-employee directors of the Company. Under the DSU Plan, non-executive directors may receive a grant of DSUs in satisfaction of their annual retainer. Each DSU is equivalent to one common share and vests on a quarterly basis. DSUs must be retained until the director leaves the Board, at which time the DSUs will be settled through common shares. In the event dividends are declared and paid, additional DSUs would be credited to reflect dividends paid on common shares. The number of DSUs to be awarded is determined based on the average closing price of the common shares on the TSX five trading days immediately prior to the date as of which fair value is determined. The fair values of the DSUs are recognized as compensation expense over the vesting period with a corresponding increase to contributed surplus.

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(expressed in US dollars, unless otherwise noted)

Income taxes

Income taxes comprise current and deferred income taxes. Income taxes are recognized in the consolidated statements of operations and comprehensive loss, except to the extent that they relate to items recognized directly in shareholders' equity, in which case the income taxes are also recognized directly in shareholders' equity.

Current income taxes are the expected income taxes payable on the taxable income for the year, using income tax rates enacted or substantively enacted, at the end of the reporting period, and any adjustment to income taxes payable in respect of previous years.

In general, deferred income taxes are recognized in respect of temporary differences arising between the income tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. Deferred income taxes are determined on a non-discounted basis using income tax rates and laws that have been enacted or substantively enacted at the consolidated balance sheet dates and are expected to apply when the deferred income tax asset or liability is settled. Deferred income tax assets are recognized to the extent that it is probable that the assets can be recovered.

Deferred income taxes are provided on temporary differences arising on investments in subsidiaries and associates, except, in the case of subsidiaries, where the timing of the reversal of the temporary difference is controlled by the Company and it is probable that the temporary difference will not reverse in the foreseeable future.

Deferred income tax assets and liabilities are presented as non-current.

Loss per share

Basic loss per common share is calculated based on the weighted average number of common shares outstanding for the year. Diluted loss per common share is calculated using the weighted average number of common shares outstanding for the year for basic net loss per common share plus the weighted average number of potential dilutive common shares that would have been outstanding during the year had potentially all common shares been issued at the beginning of the year or when the underlying share options or warrants were granted, if later, unless they were anti-dilutive.

Operating leases

Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments under an operating lease (net of any incentives received from the lessor) are recognized in the consolidated statements of operations and comprehensive loss on a straight-line basis over the period of the lease.

EcoSynthetix Inc.

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Operating segments

The Company operates in one operating segment that is reported in a manner consistent with the internal reporting provided to the chief operating decision-maker (CODM). The chief executive officer has authority for resource allocation and assessment of the Company's performance and is, therefore, the CODM.

New accounting standards

Standards issued but not yet effective or amended up to the date of issuance of the Company's consolidated financial statements are listed below. This listing is of standards and interpretations issued, which the Company reasonably expects to be applicable at a future date.

- a) In July 2014, the International Accounting Standards Board (IASB) issued the final version of IFRS 9, Financial Instruments, which reflects all phases of the financial instruments project and replaces International Accounting Standard (IAS) 39, Financial Instruments - Recognition and Measurement, and all previous versions of IFRS 9. The final version of IFRS 9 introduces new requirements for the classification, measurement and derecognition of financial instruments and introduces a new impairment model for financial assets. IFRS 9 is effective for annual periods beginning on or after January 1, 2018. The Company has assessed the impact of IFRS 9 on its interim and annual consolidated financial statements and does not expect a material change on the adoption of this standard.
- b) In May 2014, the IASB issued IFRS 15, Revenue from Contracts with Customers, which replaces IAS 18, Revenue. IFRS 15 covers principles for reporting the nature, timing, amount and uncertainty of revenue and cash flows arising from contracts with customers. IFRS 15 is effective for annual periods beginning on or after January 1, 2018. The Company has assessed the impact of IFRS 15 on its interim and annual consolidated financial statements and does not expect a material change on the adoption of this standard.
- c) On January 13, 2016, the IASB issued IFRS 16, Leases, which will replace IAS 17, Leases. The new standard will be effective for fiscal years beginning on or after January 1, 2019. Earlier application is permitted. Under the new standard, all leases will be on the balance sheet of lessees, except those that meet limited exception criteria. The Company is in the process of evaluating the impact of this standard.

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3 Risk management and financial instruments

The Company has classified its financial instruments into one of the following categories: loans and receivables, held-to-maturity and financial liabilities at amortized cost. The following table summarizes information regarding the carrying amounts of the Company's financial instruments:

	2017	2016
Loans and receivables	21,413,083	40,885,129
Held-to-maturity	30,171,121	15,043,557
Financial liabilities at amortized cost	2,991,050	3,486,091

Liquidity risk

The Company has sustained annual losses and negative cash flows from operations since its inception. Liquidity risk is the risk the Company will encounter difficulty in meeting its financial obligations associated with financial liabilities that are settled by delivering cash or another financial asset. The Company is exposed to liquidity risk as it continues to have net cash outflows to support its operations. The Company's approach to managing liquidity risk is to ensure it will have sufficient liquidity to meet liabilities when due. The Company achieves this by maintaining sufficient cash. The Company monitors its financial position on a monthly basis and updates its expected use of cash resources based on the latest available data. The Company's trade accounts payable and accrued liabilities will be paid within the next 12 months.

Credit risk

Credit risk arises from the potential that a counterparty will fail to perform its obligations. The Company is exposed to credit risk from customers. At December 31, 2017, the Company's four largest customers accounted for 62% (2016 - three customers at 66%) of trade accounts receivable. In order to minimize the risk of loss for accounts receivable, the Company's extension of credit to customers involves a review and approval by senior management. The majority of the Company's sales are invoiced with payment terms up to 63 days. The Company's objective is to minimize its exposure to credit risk from customers in order to prevent losses on financial assets by performing regular monitoring of overdue balances and to provide an allowance for potentially uncollectible accounts receivable.

The Company's trade accounts receivable have a carrying amount of \$2,012,410 at December 31, 2017 (2016 - \$1,915,469), representing the maximum exposure to credit risk of those financial assets, exclusive of the allowance for doubtful accounts. The Company's exposure to credit risk for trade accounts receivable by geographic area at December 31 was as follows:

	2017 %	2016 %
Americas	42	31
EMEA	32	14
Asia Pacific	26	55
	<hr/> 100	<hr/> 100

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The Company may also have credit risk relating to cash, which it manages by dealing with large chartered Canadian and US banks. The Company's objective is to minimize its exposure to credit risk in order to prevent losses on financial assets by placing its investments in lower risk deposits of these chartered banks. The Company's cash carrying amount is \$19,116,828 at December 31, 2017 (2016 - \$38,517,278), representing the maximum exposure to credit risk of these financial assets. Approximately 94% (2016 - 99%) of the Company's cash at December 31, 2017 was held with one financial institution. The Company's exposure to credit risk relating to cash segmented by geographic area at December 31 was as follows:

	2017 %	2016 %
Canada	94.0	98.9
United States of America	3.1	0.8
The Netherlands	2.9	0.3
	100.0	100.0

Foreign currency risk

Foreign currency risk arises because of fluctuations in foreign currency exchange rates. The Company conducts a portion of its business activities in currencies other than the functional currency of the parent company (US dollars). This primarily includes Canadian dollar and euro denominated transactions. The Company's objective in managing its foreign currency risk is to minimize its net exposure to foreign currency cash flows by converting foreign denominated financial assets into US dollars to the extent practical to match the obligations of its financial liabilities. Financial assets and financial liabilities denominated in foreign currencies will be affected by changes in the exchange rate between the functional currency and these foreign currencies. This primarily includes cash, accounts receivable and trade accounts payable and accrued liabilities, which are denominated in foreign currencies. The Company realized foreign currency exchange gains in the year ended December 31, 2017 of \$107,327 (2016 - gain of \$185,119). The Company has unrealized foreign exchange gains in the year ended December 31, 2017 of \$60,726 (2016 - nominal).

If a shift in the Canadian dollar relative to the US dollar of 10% were to occur, the foreign currency exchange gain or loss on the net financial assets would be \$242,389 (2016 - \$396,235) and this amount would be recorded in the consolidated statements of operations and comprehensive loss.

If a shift in the euro relative to the US dollar of 10% were to occur, the exchange gain or loss on the net financial assets would be \$25,353 (2016 - nominal).

Interest rate risk

Interest rate risk arises because of the fluctuation in market interest rates. The Company's objective in managing interest rate risk is to maximize the return on its cash. The Company is subject to interest rate risk on its cash. If a shift in interest rates of 10% were to occur, the impact on the consolidated statements of operations and comprehensive loss for the year would be a gain or loss of \$26,740 (2016 - \$27,159). The Company is not subject to interest rate risk on its fixed rate term deposits.

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(expressed in US dollars, unless otherwise noted)

Fair value

The carrying amounts of accounts receivable approximate their fair values given their short-term nature.

Fair value measurement recognized in the consolidated balance sheets

Financial instruments that are measured at fair value are grouped into Levels 1 to 3, based on the degree to which their fair value is observable.

- Level 1 - Fair value measurements are those derived from quoted prices (unadjusted) in active markets for identical financial assets or financial liabilities.
- Level 2 - Fair value measurements are those derived from inputs other than quoted prices included within Level 1 that are observable for the financial asset or financial liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices).
- Level 3 - Fair value measurements are those derived from valuation techniques that include inputs for the financial asset or financial liability that are not based on observable market data (unobservable inputs).

The Company's financial assets and liabilities at fair value at December 31, 2017 were as follows:

	Level 1	Level 2	Level 3	Total
Cash	19,116,828	-	-	19,116,828
Accounts receivable	-	2,296,255	-	2,296,255
	<hr/>	<hr/>	<hr/>	<hr/>
	19,116,828	2,296,255	-	21,413,083

The Company's financial assets and liabilities at fair value at December 31, 2016 were as follows:

	Level 1	Level 2	Level 3	Total
Cash	38,517,278	-	-	38,517,278
Accounts receivable	-	2,199,289	-	2,199,289
Government grants receivable	-	168,562	-	168,562
	<hr/>	<hr/>	<hr/>	<hr/>
	38,517,278	2,367,851	-	40,885,129

During the year, there were no reclassifications into or out of Level 3.

4 Capital management

The Company's objective in managing capital is to ensure sufficient liquidity to pursue its growth strategy and fund research and product development, while at the same time taking a conservative approach toward financial leverage and management of financial risk. The Company's capital is composed of total shareholders' equity. The total capital at December 31, 2017 is \$58,397,584 (2016 - \$63,757,547). The Company's primary uses of capital are financing operations, non-cash working capital and capital expenditures. The Company currently funds these requirements from existing cash resources and cash raised through share issuances. The

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(expressed in US dollars, unless otherwise noted)

Company's objectives when managing capital are to ensure the Company will continue to have enough liquidity so that it can provide its products and services to its customers and returns to its shareholders. The Company monitors its capital on the basis of the adequacy of its cash resources to fund its business plan. In order to maximize the capacity to finance the Company's ongoing growth, the Company does not currently pay a dividend to holders of its common shares.

5 Term deposits

During the fiscal year ended December 31, 2017, the Company purchased a \$15.0 million fixed term term deposit at a fixed rate of 1.6% with interest due on the maturity date of June 19, 2018. During the fiscal year ended December 31, 2016, the Company purchased a \$15.0 million fixed term term deposit at a fixed rate of 1.74% with interest payments due semi-annually and the final payment due on the maturity date of January 8, 2018. Both term deposits were purchased with a large chartered Canadian bank. The carrying value of the term deposit includes accrued interest and is recorded at amortized cost using the effective interest method. The Company has classified the investment as 'held-to-maturity'.

6 Accounts receivable

	2017	2016
Trade accounts receivable	2,012,410	1,915,469
Commodity taxes receivable and other	283,845	283,820
	<hr/>	<hr/>
	2,296,255	2,199,289

The aging of trade accounts receivable at each reporting date was as follows:

	2017	2016
Current	1,871,619	1,897,306
Past due 1 - 30 days	140,791	18,163
Past due 31 - 60 days	-	-
Past due 61 - 90 days	-	-
Past due greater than 91 days	-	-
	<hr/>	<hr/>
	2,012,410	1,915,469

7 Inventory

	2017	2016
Raw materials	268,033	673,557
Finished goods	2,267,201	2,542,459
	<hr/>	<hr/>
	2,535,234	3,216,016

The Company does not have a recorded provision (2016 - \$58,402) against finished goods and raw materials inventory.

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(expressed in US dollars, unless otherwise noted)

Inventories recognized as an expense during the year amounted to \$11,873,763 (2016 - \$9,644,394).

8 Government grants

In September 2014, the Company announced that it would receive a grant of approximately \$2.0 million from Agriculture and Agri-Food Canada through a national Bioproducts cluster that was developed by BioIndustrial Innovation Canada (the grant). The grant was provided in support of accelerated commercialization for new bio-based platforms targeting the replacement of non-renewable chemicals. The grant could be repayable in the event a condition of default occurs. The Company has met the conditions of the grant in fiscal 2016 and has accordingly recognized this grant in its operating results. The Company has recognized the remaining available balance of the grant in 2016 and accordingly has not recognized any amounts in 2017. The total claims for the years ended December 31 were as follows:

	2017	2016
Operating expenses	-	669,960

During the year ended December 31, 2017, the Company collected cash of \$114,925 (2016 - \$1,029,955) relating to claims under the grant. There is no outstanding balance receivable under the grant for the year ended December 31, 2017 as all claims have been made and collected.

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(expressed in US dollars, unless otherwise noted)

9 Property, plant and equipment

The composition of the net carrying amount of the Company's property, plant and equipment is presented in the following table:

	Machinery and equipment	Leasehold improvements	Computer hardware	Total
Cost				
January 1, 2016	15,317,018	948,540	302,380	16,567,938
Additions	484,773	-	-	484,773
Disposals	(323,765)	(116,697)	(209,705)	(650,167)
December 31, 2016	15,478,026	831,843	92,675	16,402,544
Additions	360,240	-	-	360,240
Disposals	(32,015)	-	(2,584)	(34,599)
December 31, 2017	15,806,251	831,843	90,091	16,728,185
Accumulated depreciation				
January 1, 2016	(6,610,224)	(948,540)	(263,102)	(7,821,866)
Depreciation expense	(1,282,450)	-	(14,811)	(1,297,261)
Accumulated depreciation on disposals	323,765	116,697	209,705	650,167
December 31, 2016	(7,568,909)	(831,843)	(68,208)	(8,468,960)
Depreciation expense	(1,174,541)	-	(3,611)	(1,178,152)
Accumulated depreciation on disposals	32,015	-	2,584	34,599
December 31, 2017	(8,711,435)	(831,843)	(69,235)	(9,612,513)
Net carrying amount				
December 31, 2016	7,909,117	-	24,467	7,933,584
December 31, 2017	7,094,816	-	20,856	7,115,672

The Company invested \$360,240 (2016 - \$584,773) in capital asset additions for the year ended December 31, 2017. The additions primarily relate to equipment for production.

During the year ended December 31, 2017, depreciation expense of \$811,329 (2016 - \$764,112) has been charged to cost of goods sold, \$nil (2016 - \$14,811) has been charged to selling, general and administrative expenses and \$417,792 (2016 - \$561,392) has been charged to research and development.

10 Trade accounts payable and accrued liabilities

	2017	2016
Trade accounts payable	1,530,410	1,478,184
Accrued liabilities	1,420,810	1,592,019
	<u>2,951,220</u>	<u>3,070,203</u>

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Notes to Consolidated Financial Statements

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(expressed in US dollars, unless otherwise noted)

11 Key management compensation

Key management personnel includes those individuals having authority and responsibility for planning, directing and controlling the activities of the Company directly or indirectly. Key management personnel includes the directors, chief executive officer, chief financial officer and other key members of the executive team. The compensation paid or payable to key management personnel for employee services is shown below:

	2017	2016
Salaries and other short-term employee benefits	1,273,288	1,259,747
Share-based payments	708,460	437,963
	<u>1,981,748</u>	<u>1,697,710</u>

12 Share-based compensation

At December 31, 2017, the Company had outstanding share options to purchase 4,925,647 common shares of the Company. The share options expire at various dates through January 7, 2025.

	Number of share options outstanding	Weighted average exercise price (CA\$)
Outstanding - December 31, 2015	4,350,952	2.02
Share options cancelled	(459,108)	2.52
Share options granted	1,116,520	1.28
Share options forfeitures	(315,067)	2.36
Share options exercised	<u>(90,500)</u>	1.00
Outstanding - December 31, 2016	4,602,797	1.59
Share options granted	600,985	2.20
Share options forfeitures	(208,328)	1.83
Share options exercised	<u>(69,807)</u>	0.89
Outstanding - December 31, 2017	<u>4,925,647</u>	1.66

The weighted average contractual life of the outstanding share options at December 31, 2017 is 4.8 years (2016 - 5.3 years). The total number of share options exercisable at December 31, 2017 is 2,997,620 (2016 - 2,369,519), which have a weighted average exercise price of CA\$1.77 (2016 - CA\$1.82) per share.

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Notes to Consolidated Financial Statements December 31, 2017 and December 31, 2016

(expressed in US dollars, unless otherwise noted)

	Number of share options outstanding	
	2017	2016
Range of exercise prices		
\$0.01 - \$0.50	-	-
\$0.51 - \$1.00	375,917	435,267
\$1.00 - \$1.50	3,014,990	3,156,603
\$1.50 - \$2.00	284,601	290,510
\$2.00 - \$2.50	549,744	-
\$2.50 - \$3.00	421,748	421,748
\$3.00 - \$3.50	177,327	177,327
\$3.50 - \$4.00	12,671	25,342
\$4.00 - \$4.50	-	-
\$4.50 - \$5.00	-	-
\$5.00 - \$5.50	23,500	24,500
\$5.50 - \$6.00	-	-
\$6.00 - \$6.50	-	-
\$6.50 - \$7.00	-	-
\$7.00 - \$7.50	65,149	71,500
	<u>4,925,647</u>	<u>4,602,797</u>

For the years ended December 31, the Company determined the fair values of share options using the Black-Scholes option pricing model with the following assumptions for share option grants:

	2017	2016
Expected dividend yield	-%	-%
Risk-free interest rate	1.11%	0.63%
Expected share option life (in years)	5	5
Volatility	55%	57%

The aggregate fair value of share options granted during the year is CA\$625,024 (2016 - CA\$638,249). The weighted average fair value of the share options is CA\$0.80 (2016 - CA\$0.57) per share. During the fiscal year ended December 31, 2017, the Company recognized a share-based compensation expense of \$715,282 (2016 - \$409,812) related to share options with a corresponding increase in contributed surplus.

For the year ended December 31, 2017, expected volatility is based on a review of historical volatilities for the Company.

The expected share option life is based on the employees' historical exercise behaviour.

The risk-free interest rate used for each grant is equal to the Canadian treasury bill rates in effect at the date of grant for instruments with a term similar to the expected life of the related share option.

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(expressed in US dollars, unless otherwise noted)

a) Performance share options

Under the Company's Long-Term Incentive Plan (LTIP), which was adopted in 2013, the Company may issue PSOs to employees, directors and officers in accordance with the Company's 2011 stock option plan (2011 Plan). The purpose of the 2011 Plan is to attract, retain and motivate employees of the Company. During the current fiscal year, the Company issued 600,985 PSOs in accordance with the provisions of the LTIP resulting in a total of 2,155,580 PSOs outstanding at December 31, 2017. For the year ended December 31, 2017, the Company determined that a portion of the performance hurdles related to the PSOs were achieved and recognized share-based compensation expense of \$603,590 (2016 - \$409,812) accordingly.

b) Restricted share unit plan

On March 5, 2013, the Board approved the adoption of an RSU Plan as part of the Company's LTIP, which was subsequently approved by shareholders on May 8, 2013. The purpose of the RSU Plan is to attract, retain and motivate employees of the Company. During the current fiscal year, the Company issued 96,348 (2016 - 174,209) RSUs in accordance with the provisions of the RSU Plan resulting in 387,396 RSUs outstanding at December 31, 2016. For the year ended December 31, 2017, the Company recorded share-based compensation expense of \$136,136 (2016 - \$226,495) related to RSUs that were issued that vested over three years with no performance hurdles.

c) Deferred share unit plan

On March 5, 2013, the Board approved the adoption of a DSU Plan, which was subsequently approved by shareholders on May 8, 2013. During the fiscal year ended December 31, 2017, 79,167 (2016 - 193,470) DSUs were issued to non-employee directors of the Company. During the fiscal year ended December 31, 2017, the Company recognized a share-based compensation expense of \$183,286 (2016 - \$195,957) related to DSUs with a corresponding increase in contributed surplus. At December 31, 2017, 314,558 DSUs were outstanding (2016 - 303,345).

13 Common shares

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

	Number of common shares	Share capital
Balance - December 31, 2015	59,275,758	493,182,209
DSUs exercised	13,456	50,056
Common share options exercised	90,500	127,347
	<hr/>	<hr/>
Balance - December 31, 2016	59,379,714	493,359,612
Common share options exercised	69,807	81,356
Restricted share units exercised	63,047	119,885
Deferred share units exercised	60,990	70,642
	<hr/>	<hr/>
Balance - December 31, 2017	59,573,558	493,631,495

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Notes to Consolidated Financial Statements

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(expressed in US dollars, unless otherwise noted)

14 Income taxes

The difference between income tax expense and the income taxes as computed based on the statutory rate is as follows:

	2017	2016
Net loss before income taxes	(6,442,284)	(9,304,598)
Income tax benefit at statutory rate	(1,707,204)	(2,465,718)
Cost (benefit) resulting from		
Research and development credit	(35,622)	(53,260)
Deferred income tax assets expired	1,296	1,548
Change in tax rate	5,203,138	-
Deferred income tax assets not recognized and other	(3,461,608)	2,517,430
	-	-

The reduction of the Federal corporation tax rate in the United States from a maximum rate of 35% to a flat rate of 21% was substantively enacted on December 22, 2017 and will be effective from January 1, 2018. As a result, the relevant deferred tax balances have been remeasured. The impact of the change in tax rate is a net expense of \$5,203,138 as follows:

	2017	2016
Net operating loss carry-forward	5,502,955	-
Deferred compensation and other	(299,817)	-
	5,203,138	-

Estimated temporary differences in the timing of recognition of expenses for accounting and income tax purposes at December 31 result in deferred income taxes as follows:

	2017	2016
Estimated deferred income tax assets attributable to		
Net operating loss carry-forwards	24,701,453	28,992,509
Research and development credits	2,871,226	2,689,455
Other deferred income tax assets	2,775,414	2,092,035
Deferred income tax assets	30,348,093	33,773,999
Deferred income tax assets not recognized and other	(30,348,093)	(33,773,999)
Net deferred income tax assets	-	-

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The estimated net operating loss carry-forwards and estimated research and development credits expire as follows:

	United States of America		Canada and the Netherlands	Canada
	Net operating loss carry-forwards	Research and development credits	Net operating loss carry-forwards	Research and development credits
Year ending December 31,				
2018	388,421	-	10,963	-
2019	1,561,172	11,664	12,176	-
2020	2,063,163	42,132	470,822	-
2021	2,564,511	55,822	1,175,369	-
2022	1,338,594	52,731	383,011	-
2023	1,321,285	44,965	2,159,395	-
2024	1,532,264	46,333	484,488	-
2025	1,629,456	47,245	247,824	-
2026	1,562,856	41,905	2,160,003	-
2027	2,011,361	35,351	-	-
2028	2,717,038	69,118	2,387	-
2029	2,854,334	63,226	-	-
2030	1,207,399	96,302	-	43,273
2031	3,927,982	-	2,855,752	347,223
2032	1,127,104	-	4,060,378	548,161
2033	10,855,248	-	7,773,855	641,578
2034	1,333,972	-	11,565,109	560,868
2035	1,058,892	-	17,752,622	343,233
2036	1,275,377	-	6,899,485	193,678
	-	-	3,390,564	191,225
	42,330,429	606,794	61,404,203	2,869,239

15 Commitments

The Company has entered into the following financial commitments:

	\$
Year ending December 31, 2018	1,609,665
2019	304,373
2020	279,009
Thereafter	-
	<u>2,193,047</u>

During the normal course of operations, the Company may enter into feedstock contracts to secure raw material availability over a 12-month period based on market pricing at the time of purchase. At December 31, 2017, the Company was committed to purchases of feedstock of approximately \$954,232.

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The Company has a forgivable loan agreement with the Province of Ontario under its Innovation Demonstration Fund Program (Ontario), pursuant to which Ontario has provided a forgivable loan up to CA\$3.1 million for a specific technology demonstration project. This loan is forgivable in the event no conditions of default have occurred, the technology is not commercialized outside the Province of Ontario and various other documentation requirements are met. Management has determined that there is reasonable assurance the Company will comply with these conditions.

16 Segmented information and enterprise wide disclosures

Segmented reporting

The Company operates in one reportable segment and generates revenue primarily from its biopolymer nanosphere technology platform.

Sales by geographic location

The Company is domiciled in Canada. During the year ended December 31, 2017, revenue from external customers located in Canada was \$3,586,282 (2016 - \$2,596,629). The total revenue from external customers in the following regions is as follows:

	2017	2016
Americas	9,339,667	6,748,961
EMEA	4,416,090	1,712,483
Asia Pacific	4,129,666	4,815,942
	<u>17,885,423</u>	<u>13,277,386</u>

The revenue has been assigned to each jurisdiction, based on the location of the customer. In situations where a sale is made through a reseller, revenue associated with that sale is attributed to the geographic region of the end customer. During the year ended December 31, 2017, revenue attributable to individual countries representing greater than 10% of total revenues included United States, Japan, Canada, Germany and Finland, which represented 28%, 21%, 20%, 13% and 11%, respectively.

During the year ended December 31, 2016, revenue attributable to the individual countries representing greater than 10% of total revenues included Japan, United States and Canada, which represented 30%, 24% and 20%, respectively.

Sales to major customers

The Company derives a significant portion of its revenues from certain customers. Three customers represented 21%, 20% and 16%, respectively, of total revenue for the year ended December 31, 2017 (2016 - three customers represented 30%, 19% and 11%, respectively). The concentrations listed do not necessarily apply to the same customer year over year.

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Property, plant and equipment

The Company's property, plant and equipment, reported at their net carrying amount, are located in the following countries:

	2017	2016
Canada	1,792,596	2,174,420
United States of America	2,687,492	2,944,100
The Netherlands	2,635,584	2,815,064
	<u>7,115,672</u>	<u>7,933,584</u>

17 Expenses by nature

Additional information on the nature of amounts included in cost of sales, selling, general and administrative and research and development is as follows:

	2017	2016
Wages and salaries, including benefits	4,501,510	4,909,376
Termination benefits	63,485	531,909
Share-based compensation	1,034,704	832,265
Depreciation	1,229,121	1,340,315
Foreign exchange loss (gain)	11,676	(87,130)

Foreign exchange losses represent the revaluation of monetary assets and liabilities denominated in foreign currencies. The change in foreign exchange revaluation gains and losses is primarily due to foreign exchange rate fluctuations between the US dollar (the Company's functional currency) and foreign currencies and the related impact on the net monetary position in those respective currencies. The foreign exchange losses for the year ended December 31, 2017 primarily relate to monetary assets and liabilities denominated in Canadian dollars.

18 Loss per share

Basic loss per share is calculated by dividing the profit attributable to equity holders of the Company by the weighted average number of common shares in issue during the year.

Diluted loss per share is equivalent to basic loss per share, as the consideration of potentially dilutive securities would be anti-dilutive.