# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION
**Washington, D.C. 20549**

# FORM 8-K/A

**CURRENT REPORT**
**Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

Date of Report (Date of earliest event reported): **October 2, 2017**

# RESHAPE LIFESCIENCES INC.
(Exact name of registrant as specified in its charter)

| **Delaware** | **1-33818** | **48-1293684** |
|---|---|---|
| (State or other jurisdiction of incorporation) | (Commission File Number) | (I.R.S. Employer Identification Number) |

| **2800 Patton Road St. Paul, Minnesota** | **55113** |
|---|---|
| (Address of principal executive offices) | (Zip Code) |

**(651) 634-3003**
(Registrant’s telephone number, including area code)

**Not applicable.**
(Former name or former address, if changed since last report)

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions:

o Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)

o Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)

o Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))

o Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))

Indicate by check mark whether the registrant is an emerging growth company as defined in Rule 405 of the Securities Act of 1933 (§230.405 of this chapter) or Rule 12b-2 of the Securities Exchange Act of 1934 (§240.12b-2 of this chapter).

Emerging growth company o

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. o

**Explanatory Note**

On October 3, 2017, ReShape Lifesciences Inc. (formerly known as EnteroMedics Inc.), a Delaware corporation (the “Company”), filed a Current Report on Form 8-K (the “Original Report”) with the Securities and Exchange Commission to report that effective as of October 2, 2017, the Company completed the acquisition of ReShape Medical, Inc., a Delaware corporation (“ReShape Medical”), through the merger of Nixon Subsidiary Inc., a Delaware corporation and wholly owned subsidiary of the Company, with and into ReShape Medical, and subsequent merger of ReShape Medical with and into Nixon Subsidiary Holdings LLC (now known as ReShape Medical LLC), a Delaware limited liability company and wholly owned subsidiary of the Company (the “Merger”).

This amendment to the Original Report is being filed to provide the financial statements and pro forma financial information required by Items 9.01(a) and 9.01(b), respectively, of Form 8-K.

**Item 9.01 Financial Statements and Exhibits.**

(a) *Financial Statements of Businesses Acquired*.

The audited financial statements of ReShape Medical as of and for the years ended December 31, 2016 and December 31, 2015 and the unaudited interim financial statements of ReShape Medical as of and for the three and nine months ended September 30, 2017 are filed as Exhibit 99.1, Exhibit 99.2 and Exhibit 99.3, respectively, and are incorporated by reference.

(b) *Pro Forma Financial Information*.

The unaudited pro forma balance sheet as of September 30, 2017 and unaudited pro forma statements of income for the nine months ended September 30, 2017 and the year ended December 31, 2016 and the notes to such unaudited pro forma financial statements, all giving effect to the Merger, are filed as Exhibit 99.4 and incorporated by reference.

(c) *Shell Company Information*.

Not applicable.

(d) *Exhibits*.

| Exhibit No. | Description |
|---|---|
| 23.1 | Consent of Ernst & Young LLP, independent registered public accounting firm for ReShape Medical, Inc. for the year ended December 31, 2016 |
| 23.2 | Consent of Haskell & White LLP, independent registered public accounting firm for ReShape Medical, Inc. for the year ended December 31, 2015 |
| 99.1 | Audited financial statements of ReShape Medical, Inc. as of and for the year ended December 31, 2016 |
| 99.2 | Audited financial statements of ReShape Medical, Inc. as of and for the year ended December 31, 2015 |
| 99.3 | Unaudited financial statements of ReShape Medical, Inc. as of and for the three and nine months ended September 30, 2017 |
| 99.4 | Unaudited pro forma financial statements of ReShape Lifesciences Inc. |



## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

**RESHAPE LIFESCIENCES INC.**

By: /s/ Scott P. Youngstrom
Scott P. Youngstrom
Chief Financial Officer and Chief Compliance Officer

Dated: December 15, 2017

**Exhibit 23.1**

## Consent of Independent Auditors

We consent to the incorporation by reference in the following Registration Statements:

(1) Registration Statement (Form S-8 Nos. 333-211940, 333-196646, 333-184181, 333-176174, 333-171244, 333-159592, and 333-149662) of ReShape Lifesciences, Inc.,

(2) Registration Statement (Form S-3 Nos. 333-216600, 333-205353, 333-195855, 333-183313, 333-171944, 333-171052, 333-166011, 333-161702, and 333-158516) of ReShape Lifesciences, Inc., and

(3) Registration Statement (Form S-1 Nos. 333-215590, 333-171052, 333-143265, 333-170503, and 333-213704) of ReShape Lifesciences, Inc.;

of our report dated May 25, 2017, with respect to the December 31, 2016 financial statements of ReShape Medical, Inc., included in Amendment No. 1 to this Current Report on Form 8-K of ReShape Lifesciences, Inc.

/s/ Ernst & Young LLP

Irvine, California
December 15, 2017

**Exhibit 23.2**

# CONSENT OF INDEPENDENT AUDITORS

We consent to the incorporation by reference in Registration Statements Nos. 333-211940, 333-196646, 333-184181, 333-176174, 333-171244, 333-159592, and 333-149662 on Form S-8, Registration Statement Nos. 333-216600, 333-205353, 333-195855, 333-183313, 333-171944, 333-171052, 333-166011, 333-161702, and 333-158516 on Form S-3, and Registration Statement Nos. 333-215590, 333-171052, 333-143265, 333-170503, and 333-213704 on Form S-1 of ReShape Lifesciences Inc. (the “Company”) of our report dated May 26, 2016, except for the restatement discussed in Note 1, for which the date is December 15, 2017, with respect to the balance sheet of ReShape Medical, Inc. as of December 31, 2015, and the related statements of operations, stockholders’ equity (deficit), and cash flows for the year then ended, which report appears in the Form 8-K/A of Reshape Lifesciences Inc. dated December 15, 2017.

/s/ HASKELL & WHITE LLP

Irvine, California
December 15, 2017

**Exhibit 99.1**

*Financial Statements with Report of Independent Auditors*

*As of December 31, 2016 and for the Year Then Ended*

---

**RESHAPE MEDICAL, INC.**

**YEAR ENDED DECEMBER 31, 2016**
**Table of Contents**



---

## Report of Independent Auditors

The Board of Directors
ReShape Medical, Inc.

We have audited the accompanying financial statements of ReShape Medical, Inc. which comprise the balance sheet as of December 31, 2016, and the related statements of operations and comprehensive loss, stockholders' deficit and cash flows for the year then ended, and the related notes to the financial statements.

**Management's Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these financial statements in conformity with U.S. generally accepted accounting principles; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free of 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 audit. We conducted our audit in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of 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 ReShape Medical, Inc. at December 31, 2016, and the results of its

operations and its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

**The Company's Ability to Continue as a Going Concern**

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the financial statements, the Company has recurring losses from operations and negative cash flows from operations that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 1. The financial statements do not include any adjustments that might result from the outcome of this uncertainty. Our opinion is not modified with respect to this matter.

/s/ Ernst & Young LLP

Irvine, California
May 25, 2017

**RESHAPE MEDICAL, INC.**

**Balance Sheet**

| | | December 31, 2016 |
|---|---|---|
| **Assets** | | |
| **Current assets** | | |
| Cash and cash equivalents | $ | **4,641,125** |
| Accounts receivable, net | | **694,842** |
| Inventories, net | | **1,293,708** |
| Prepaid expenses and other current assets | | **359,309** |
| Total current assets | | **6,988,984** |
| Property and equipment, net | | **329,732** |
| Other assets | | **109,430** |
| Total assets | $ | **7,428,146** |
| **Liabilities and Stockholders' Deficit** | | |
| **Current liabilities** | | |
| Accounts payable | | **364,136** |
| Current portion of notes payable | | **2,800,000** |
| Payroll-related liabilities | | **914,697** |
| Accrued and other liabilities | | **1,421,710** |
| Total current liabilities | | **5,500,543** |
| Notes payable, less current portion and unamortized debt discount of $461,842 | | **3,638,991** |
| Warrant liabilities | | **1,916,272** |
| Total liabilities | | **11,055,806** |

See accompanying notes to financial statements.



**RESHAPE MEDICAL, INC.**

**Balance Sheet (continued)**

| | December 31, 2016 |
|---|---|
| **Commitments and contingencies** (Note 8) | |
| **Stockholders' deficit** | |
| Series D Convertible Preferred Stock, $0.0001 par value; 33,798,800 shares authorized; 33,798,800 shares issued and outstanding; liquidation preference of $37,999,992 | **3,380** |
| Series C Convertible Preferred Stock, $0.0001 par value; 25,916,528 shares authorized; 22,456,174 shares issued and outstanding; liquidation preference of $18,414,064 | **2,246** |
| Series B Convertible Preferred Stock, $0.0001 par value; 6,250,000 shares authorized; 6,250,000 shares issued and | **625** |

| | | |
|---|---|---|
| outstanding; liquidation preference of $20,000,000 | | |
| Series A Convertible Preferred Stock, $0.0001 par value; 4,687,500 shares authorized; 4,687,500 shares issued and outstanding; liquidation preference of $7,500,000 | | **469** |
| Series S Convertible Preferred Stock, $0.0001 par value; 500,000 shares authorized; 500,000 shares issued and outstanding; liquidation preference of $500,000 | | **50** |
| Common Stock, $0.0001 par value; 105,000,000 shares authorized; 2,640,257 shares issued and outstanding | | **264** |
| Additional paid-in capital | | **85,457,727** |
| Accumulated deficit | | **(89,092,421)** |
| Total stockholders' deficit | | **(3,627,660)** |
| Total liabilities and stockholders' deficit | **$** | **7,428,146** |

See accompanying notes to financial statements.



## RESHAPE MEDICAL, INC.

Statement of Operations and Comprehensive Loss

| | | Year Ended December 31, 2016 |
|---|---|---|
| **Revenue** | **$** | **5,959,273** |
| **Cost of goods sold** | | **5,433,965** |
| Gross margin | | **525,308** |
| **Operating expenses** | | |
| Selling, general and administrative | | **13,253,521** |
| Regulatory and clinical | | **2,164,874** |
| Research and development | | **1,716,353** |
| Impairment charges and lease termination costs | | **674,025** |
| Total operating expenses | | **17,808,773** |
| Loss from operations | | **(17,283,465)** |
| **Other income (expense) net** | | |
| Interest expense, net | | **(803,082)** |
| Interest and investment income, net | | **60,090** |
| Revaluation of warrant liabilities | | **23,509** |
| Loss before income taxes | | **(18,002,948)** |
| **Provision for income taxes** | | **(14,716)** |
| Net loss and comprehensive loss | | **(18,017,664)** |

See accompanying notes to financial statements.



## RESHAPE MEDICAL, INC.

### Statement of Stockholders' Deficit
### For the Year Ended December 31, 2016

| | Series D Preferred Stock | | Series C Preferred Stock | | Series B Preferred Stock | | Series A Preferred Stock | | Series S Preferred Stock | | Common Stock | | Additional Paid-in Capital | Accumulated Other Comprehensive Gain / (Loss) | Accumulated Deficit | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | Shares | Amount | Shares | Amount | Shares | Amount | Shares | Amount | | | | |
| **Balance, December 31, 2015** | 33,798,800 | $ 3,380 | 22,456,174 | $ 2,246 | 6,250,000 | $ 625 | 4,687,500 | $ 469 | 500,000 | $ 50 | 2,526,633 | $ 253 | $85,060,237 | $ (21,933) | $ (71,074,757) | $13,970,570 |
| Exercise of stock options | — | — | — | — | — | — | — | — | — | — | 113,624 | 11 | 24,458 | — | — | 24,469 |
| Stock-based compensation | — | — | — | — | — | — | — | — | — | — | — | — | 373,064 | — | — | 373,064 |
| Stock issuance cost | — | — | — | — | — | — | — | — | — | — | — | — | (32) | — | | (32) |
| Net realized gain on short-term | — | — | — | — | — | — | — | — | — | — | — | — | — | 21,933 | — | 21,933 |

| | | | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| investments | | | | | | | | | | | | | | | | |
| Net loss | — | — | — | — | — | — | — | — | — | — | — | — | — | — | (18,017,664) | (18,017,664) |
| **Balance, December 31, 2016** | 33,798,800 | $ 3,380 | 22,456,174 | $ 2,246 | 6,250,000 | $ 625 | 4,687,500 | $ 469 | 500,000 | $ 50 | 2,640,257 | $ 264 | $85,457,727 | $ — | $ (89,092,421) | $ (3,627,660) |

See accompanying notes to financial statements.



**RESHAPE MEDICAL, INC.**

**Statement of Cash Flows**

| | Year Ended December 31, 2016 |
|---|---|
| **Cash flows from operating activities** | |
| Net loss | **$ (18,017,664)** |
| Adjustments to reconcile net loss to net cash used in operating activities: | |
| Depreciation and amortization expense | 243,292 |
| Impariment charges and lease termination costs | 674,025 |
| Stock-based compensation | 373,064 |
| Amortization of debt discount and issuance costs | 205,212 |
| Provision for obsolete inventories | 120,413 |
| Provision for product warranty | 134,289 |
| Provision for bad debts | 38,355 |
| Revaluation of warrant liabilities | (23,509) |
| Changes in operating assets and liabilities | |
| Accounts receivable, net | (484,583) |
| Inventories, net | (60,064) |
| Prepaid expenses and other assets | (223,903) |
| Accounts payable | (101,014) |
| Payroll-related liabilities | (47,905) |
| Accrued and other liabilities | 78,862 |
| Net cash used in operating activities | **(17,091,130)** |
| **Cash flows from investing activities** | |
| Purchases of short-term investments | (1,748,604) |
| Sales of short-term investments | 13,680,542 |
| Acquisition of property and equipment | (132,597) |
| Net cash provided by investing activities | **11,799,341** |
| **Cash flows from financing activities** | |
| Principal payments on note payable to bank | (466,666) |
| Proceeds from the exercise of options | 24,469 |
| Equity offering costs | (32) |
| Net cash used in financing activities | **(442,229)** |
| **Net decrease in cash and cash equivalents** | **(5,734,018)** |
| **Cash and cash equivalents, beginning of the year** | **10,375,143** |
| **Cash and cash equivalents, end of year** | **$ 4,641,125** |

See accompanying notes to financial statements.



**RESHAPE MEDICAL, INC.**

**Statement of Cash Flows (continued)**

| | Year Ended December 31, 2016 |
|---|---|
| **Supplemental disclosures of cash flow information:** | |
| **Cash paid during the year for:** | |
| Interest | **$ 598,521** |
| Income taxes | **$ 10,876** |
| **Supplemental schedule of non-cash financing activities:** | |

| | | |
|---|---|---|
| Purchase of leasehold improvements | $ | 26,599 |
| Disposals of property and equipment | $ | 1,787 |

See accompanying notes to financial statements.





**1. Business and Significant Accounting Policies**

*Business*

ReShape Medical, Inc. (the “Company”) was originally incorporated on August 22, 2005, under the name Abdominis, Inc., pursuant to the laws of the State of Delaware. In January 2007, the Company changed its name from Abdominis, Inc. to ReShape Medical, Inc. The Company has developed and currently markets and sells a U.S. Food and Drug Administration (FDA) approved unique non-surgical product for the treatment of obesity in the United States (U.S.).

*Basis of Presentation. Management’s Plans and Liquidity*

The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) and include all adjustments necessary for the fair presentation of the Company’s financial position, results of operations and cash flows.

The Company has incurred operating losses and has experienced negative cash flows from operations since inception and has an accumulated deficit of $89,092,421 as of December 31, 2016. The Company used cash in its operations of $17,091,130 during the year ended December 31, 2016. In August of 2015, the Company received U.S. FDA approval of its product and began selling in the U.S. in October 2015. Successful development of the market for the Company’s products and its ability to grow sales is dependent upon continued operations of the Company, which in turn is dependent upon the Company’s continued ability to raise capital and to generate cash from future revenue and operations adequate to support the Company’s cost structure.

As of December 31, 2016, the Company has cash and equivalents of $4,641,125. On January 31, 2017, the Company received proceeds of $11 million from the issuance of convertible debt to its Series D preferred stock investors. On February 1, 2017 the Company received net proceeds of $3.5 million from the completion of an amendment to its current debt agreement with its bank. The Company performed an analysis and concluded substantial doubt exists with respect to the Company being able to continue as a going concern through one year from the date of issuance of the financial statements for the year ended December 31, 2016. In order to meet its operating cash flow requirements, management’s plans include raising capital through the issuance of equity and debt instruments. While the Company’s management believes that it will continue to be successful in obtaining the necessary financing to fund its operations, there are no assurances that such additional funding will be achieved on acceptable terms, or at all. If the Company is not able to secure adequate additional funding, the Company may be forced to make reductions in spending, extend payment terms with suppliers, liquidate assets where possible, and or suspend or curtail planned programs. Any of these actions could materially harm the Company’s business, result of operations, and future prospects,





**1. Business and Significant Accounting Policies (continued)**

*Basis of Presentation. Management’s Plans and Liquidity (continued)*

including its ability to continue as a going concern. The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or amounts and classification of liabilities that might be necessary should the Company be unable to continue in existence.

*Use of Estimates*

The preparation of financial statements in conformity with GAAP requires management to make informed estimates and assumptions that affect the reported amounts of assets and liabilities, and the disclosure of contingent assets and liabilities, at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Management considers many factors in selecting appropriate financial accounting policies and controls and in developing estimates and assumptions that are used in the preparation of these financial statements. Management must apply significant judgment in this process. In addition, other factors may affect estimates, including: expected business and operational changes, sensitivity and volatility associated with the assumptions used in developing estimates, and whether historical trends are expected to be representative of future trends. The estimation process often may yield a range of potentially reasonable estimates of the ultimate future outcomes and management must select an amount that falls within that range of reasonable estimates. The most significant estimates in the accompanying financial statements relate to the valuation of the Company’s common stock, warrants, other equity awards, provision for product warranty, and obsolete and slow-moving inventory. This process may result in actual results differing materially from those estimated amounts used in the preparation of the financial statements under different assumptions or conditions.

*Cash and Cash Equivalents*

The Company considers all highly liquid investments with a maturity of three months or less, when acquired, to be cash equivalents. Substantially all of the Company's cash and cash equivalents are maintained at one financial institution domiciled in the United States. Amounts on deposit with this financial institution may, from time to time, exceed the federally-insured limit, as well as coverage provided by the Securities Investment Protection Corporation. As of December 31, 2016 all of the Company's cash and cash equivalents are held in readily available checking and money market accounts.

*Short-term Investments*

Short-term investments are comprised of commercial paper and corporate obligations with original maturity dates greater than ninety days and less than one year. The Company classifies its short-term investments as





**1. Business and Significant Accounting Policies (continued)**

*Short-term Investments (continued)*

available for sale securities with net unrealized gains or losses recorded as a component of stockholders' deficit. Realized gains and losses are included as other income (expense) in the statement of operations and comprehensive loss. The cost basis for realized gains and losses on available-for-sale securities is determined on a specific identification basis. Management determines the appropriate classification of its investments at the time of purchase and reevaluates such determination at each balance sheet date. The Company periodically reviews its investments for other than temporary declines in fair value below the cost basis and whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. As of December 31, 2016 there were no short-term investments held by the Company.

*Accounts Receivable*

Trade accounts receivable are stated at the amount the Company expects to collect. The Company maintains allowances for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. Management considers the following factors when determining the collectability of specific customer accounts: customer credit worthiness, past transaction history with the customer, current economic industry trends, and changes in customer payment terms. If the financial condition of the Company's customers were to deteriorate, adversely affecting their ability to make payments, additional allowances would be required. Based on management's assessment, the Company provides for estimated uncollectible amounts through a charge to earnings and a credit to a valuation allowance. Balances that remain outstanding after the Company has used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to accounts receivable. The Company recorded a valuation allowance of $38,355 as of December 31, 2016.

*Inventories*

Inventories are valued at the lower of cost, determined on a first-in, first-out ("FIFO") basis, or market. Management evaluates inventory for excess quantities and obsolescence and records an allowance to reduce the carrying value of inventory as determined necessary.

*Property and Equipment*

Property and equipment are recorded at cost. The Company provides for depreciation over estimated useful lives of two to three years, or the life of the related lease for leasehold improvements, if shorter, using the straight-line method. Repairs and





**1. Business and Significant Accounting Policies (continued)**

maintenance expenditures that do not significantly add value to property and equipment, or prolong its life, are charged to operations as incurred. Gains and losses on dispositions of property and equipment are included in the operating results of the related period.

*Impairment of Long-lived assets*

The Company will record impairment losses on long-lived assets used in operations when events and circumstances indicate that assets might be impaired and the undiscounted cash flows estimated to be generated by those assets are less than the carrying amount of those assets. An impairment analysis is subjective and assumptions regarding future growth rates and operating expense levels can have a significant impact on the expected future cash flows and impairment analysis. In December 2016, the Company recognized an impairment of $208,383 for leasehold improvements due to its plan to move to a new facility. The amount is included in impairment charges and lease termination cost in the statement of operations and comprehensive loss.

While the Company's current and historical operating losses and cash flows are indicators of impairment, the Company believes that future cash flows from operating activities and financing activities will exceed the carrying value of its long-lived assets and accordingly, exclusive of the above, the Company has not recognized any other impairment losses through December 31, 2016.

*Concentrations*

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash, short-term investments and accounts receivable. The Company maintains balances that at times may exceed amounts that are federally-insured or insured by the Securities Investor Protection Corporation. Management mitigates such potential risks by maintaining the Company's cash and short-term investment balances with entities that management believes possess high-credit quality and does not anticipate any losses with regards to these amounts.

The Company believes the concentration of credit risk in its accounts receivable is mitigated by its credit evaluation process, relatively short collection terms and the level of credit worthiness of its customers.





**1. Business and Significant Accounting Policies (continued)**

*Fair Value Measurements*

The Company measures fair value based on a three-level hierarchy of inputs, of which the first two are considered observable and the last unobservable. Unobservable inputs reflect the Company's own assumptions about current market conditions. The three-level hierarchy of inputs is as follows:

- Level 1 — Observable inputs such as unadjusted 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 - Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported by little or no market activity).

The fair value of the Company's financial assets and liabilities measured on a recurring basis is as follows:

| | Balance as of December 31, 2016 | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs |
|---|---|---|---|---|
| Assets | | | | |
| Cash equivalents | $ 2,566,512 | $ 2,566,512 | $ — | $ — |
| | $ 2,566,512 | $ 2,566,512 | $ — | $ — |

| | Balance as of December 31, 2016 | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs |
|---|---|---|---|---|
| Liabilites | | | | |
| Warrant liability | $ 1,916,272 | $ — | $ — | $ 1,916,272 |
| | $ 1,916,272 | $ — | $ — | $ 1,916,272 |

The fair value of the Company's cash equivalents were determined using Level 1 inputs. Unadjusted quoted prices for these securities are regularly provided to the Company by independent pricing services.

The fair value of the Company's Series C Preferred Stock warrants were determined by the use of the Black-Scholes option-pricing model under the following assumptions:





**1. Business and Significant Accounting Policies (continued)**

*Fair Value Measurements (continued)*

| | |
|---|---|
| Expected volatility | 48.0%-50.0% |

| | |
|---|---|
| Dividend yield | 0% |
| Risk-free interest rate | 2.25%-2.35% |
| Expected term | 3-8 years |
| Fair value of Series C Preferred Stock | $0.98 |

Given the absence of a public trading market, the Company determined the fair value of the Series C Preferred Stock through the use of objective and subjective factors. These factors included, but were not limited to (i) valuations performed by unrelated third-party specialists which included fair value estimates about the Company's securities and (ii) the prices for Series C Preferred Stock sold in the Company's preferred stock purchase agreements.

*Stock warrants*

The Company has issued freestanding warrants to purchase shares of its convertible preferred stock which are accounted for as a liability due to the nature of the underlying redemption provisions of the preferred stock into which the warrants are exercisable. The warrants are recorded on the Company's balance sheet at their fair value as determined on the date of issuance and are revalued at each subsequent balance sheet date, with fair value changes recognized as other income or expense in the accompanying statement of operations and comprehensive loss. The Company will continue to adjust the liability for changes in fair value until the earlier of the exercise or expiration of the warrants, the completion of a deemed liquidation event, the conversion of convertible preferred stock into common stock, or until the holders of the convertible preferred stock can no longer trigger a deemed liquidation event. Pursuant to the terms of these warrants, upon the conversion of the class of preferred stock underlying the warrant, the warrants automatically become exercisable for shares of the Company's common stock based upon the conversion ratio of the underlying class of preferred stock. The consummation of an initial public offering will result in the conversion of all classes of the Company's preferred stock into common stock. Upon such conversion of the underlying classes of preferred stock, the warrants will be classified as a component of equity and will no longer be subject to re-measurement. The Company estimates the fair value of the liability using option pricing models and assumptions that are based on the individual characteristics of the warrants or instruments on the valuation date, including assumptions for expected volatility, expected life, yield, and risk-free interest rate.





**1. Business and Significant Accounting Policies (continued)**

*Stock warrants (continued)*

A summary of preferred stock warrant activity for the year ended December 31, 2016 is as follows:

| | Number of Shares | Liability |
|---|---|---|
| Balance, December 31, 2015 | 3,460,354 | $ 1,939,781 |
| Issuances | — | — |
| Exercises | — | — |
| Change in fair value | — | (23,509) |
| Balance, December 31, 2016 | 3,460,354 | $ 1,916,272 |

There were no transfers between levels within the fair value hierarchy during the periods presented.

*Revenue Recognition*

Revenue is recognized when persuasive evidence of the arrangement exists, delivery and performance has occurred, the price is fixed and determinable and collectability is probable. Generally, these criteria are met at the time products are shipped. Provisions for discounts are recorded and are classified as reductions to revenues.

*Shipping and Handling*

The Company records amounts invoiced to its customers for outbound freight and shipping as revenue and the related expense as cost of goods sold.

*Warranty Accrual*

The Company's products are covered by a one year warranty policy against defective products at the time of shipment. In the event that a product is defective, the Company may replace the product or refund the purchase price or a portion thereof. The Company estimates future warranty costs by analyzing the timing, cost and amount of returned





**1. Business and Significant Accounting Policies (continued)**

product and by considering future expectations. Assumptions and historical warranty experience are evaluated periodically to determine the continued appropriateness of such assumptions. The Company recorded a reserve for warranty claims in the amount of approximately $171,000 as of December 31, 2016, which is included within accrued and other liabilities on the accompanying balance sheet.

*Foreign Currency*

The Company maintains a foreign bank account for purposes of collecting trade receivables from foreign customers. Foreign bank balances are translated at the rates of exchange at the balance sheet date. Gains and losses resulting from foreign currency transactions are recorded within other income in the accompanying statement of operations and comprehensive loss.

*Patent-related Expenditures*

Expenditures related to patent research and applications, which are primarily comprised of legal fees, are expensed as incurred.

*Research and Development*

Research and development costs are expensed when incurred.

*Income Taxes*

The Company uses the asset and liability method of accounting for income taxes. Accordingly, deferred tax liabilities and assets are determined based on the difference between the financial statement and tax bases of assets and liabilities, using enacted tax rates in effect for the year in which the differences are expected to reverse. Current income taxes are based on the year's taxable income for federal and state income tax reporting purposes. The likelihood of realizing the tax benefits related to a potential deferred tax benefit is evaluated, and a valuation allowance is recognized to reduce that deferred tax asset if it is more likely than not that all or some portion of the deferred tax asset will not be realized.

The Company's net deferred tax assets at December 31, 2016 and consist principally of net operating losses and the Company provided a 100% valuation allowance for the tax effect of these net operating losses. No benefit for income taxes has been provided in the accompanying statements of operations and comprehensive loss since all deferred tax assets have been fully reserved. The Company provided the valuation allowance since management could not determine that it was "more likely than not" that the benefits of the deferred tax assets would be realized.





**1. Business and Significant Accounting Policies (continued)**

The Company is required to file federal and state income tax returns in the United States and various other state jurisdictions. The preparation of these state tax returns requires the Company to interpret the applicable tax laws and regulations in effect in such jurisdictions, which could affect the amount of tax paid by the Company.

*Uncertain Tax Positions*

GAAP prescribes a comprehensive model for how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that it has taken or expects to take on a tax return. A favorable tax position may be included in the calculation of tax liabilities and expenses if a company concludes that it is more likely than not that its adopted tax position will prevail if challenged by tax authorities. Where applicable, associated interest and penalties are also recorded. The Company did not recognize any adjustments regarding its tax accounting treatments for the year ended December 31, 2016. The Company is subject to continuous examination of its income tax returns by the U.S. Internal Revenue Service and other tax authorities since inception.

*Stock-based Compensation*

The Company accounts for stock options granted to employees, directors and consultants using a fair value method, which requires the recognition of compensation expense for costs related to all stock-based payments, including stock options. The Company's employee share-based awards result in a cost that is measured at fair value on the awards' grant date, using a Black-Scholes option-pricing model, based on the estimated number of awards that are expected to vest. Stock-based compensation is recognized on a straight-line basis over the award vesting period.

Transactions with non-employees in which goods or services are the consideration received for the issuance of equity instruments are accounted for based on the fair value of the consideration received or the fair value of the equity instrument issued, whichever is more reliably measurable. The measurement date of the fair value of the equity instrument issued is the earlier of the date on which the counterparty's performance is complete or the date on which it is probable that performance will occur.

The Black-Scholes option-pricing model requires assumptions, such as the value of the Company's common stock, the risk-free interest rate, dividend yield, expected term and expected volatility. Further, the forfeiture rate also affects the amount of aggregate compensation. The following assumptions are subjective and generally require significant management judgment:

**1. Business and Significant Accounting Policies (continued)**

_Stock-based Compensation (continued)_

*Common stock value* — the fair value of the shares of common stock underlying stock options is determined by the Company's Board of Directors (the "Board") for the stock option plan. Since there is no public market for the common stock, the Board determines the common stock fair value at the time of each option grant by considering a number of objective and subjective factors. These include the valuation of several public peer group companies within the medical device industry that focus on technological advances and development that the Board believes is comparable to the Company's operations. Factors such as operating and financial performance, the lack of liquidity of the common stock and trends in the broader economy and medical device industry also have an impact on the determination of the fair value of the common stock. In addition, the Company regularly engages a third party valuation specialist to assist with estimates related to the valuation of the common stock.

*Expected volatility* — Since the Company does not have sufficient stock price history to estimate the expected volatility of its shares, the expected volatility is calculated based on the average volatility for a public company peer group in the industry in which the Company does business.

*Dividend yield of zero* — The Company has not paid, and does not intend to pay, dividends.

*Risk-free interest rates* — The Company applies the risk-free interest rate based on the U.S. Treasury yield for the expected term of the option.

*Expected term* — For employees, the Company calculated the expected term using the "simplified method", which represents the average of the contractual term of the option and the vesting period for its employee stock options. For non-employees, the Company estimated the expected term as the contractual term of the award.

*Forfeiture rate* — estimated at the time of the grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

_Comprehensive Income (Loss)_

Comprehensive income (loss) is defined as the change in equity during a period from transactions and other events from non-owner sources. The components of comprehensive income (loss), including net loss, are reported in the financial statements in the period in which they are recognized. Net loss and other comprehensive loss shall be reported, net of their related tax effect to arrive at comprehensive loss. The Company did not have any unrealized income or losses on short-term investments to recognize for the year ended December 31, 2016.





**1. Business and Significant Accounting Policies (continued)**

_Recent Accounting Pronouncements_

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") ASU 2014-09 regarding ASC Topic 606, *Revenue from Contracts with Customers*. The standard provides principles for recognizing revenue for the transfer of promised goods or services to customers with the consideration to which the entity expects to be entitled in exchange for those goods or services. This guidance becomes effective for the Company beginning fiscal year 2019 with early adoption permitted as of January 1, 2017. Management is currently evaluating the accounting, transition and disclosure requirements of the standard to determine the financial statement impact of adoption.

In August 2014, the FASB issued ASU No. 2014-15, *Disclosure of Uncertainties About an Entity's Ability to Continue as a Going Concern*. The standard requires management to perform interim and annual assessments of an entity's ability to continue as a going concern within one year of the date the financial statements are issued and provides guidance on determining when and how to disclose going concern uncertainties in the financial statements. Certain disclosures are required if conditions given rise to substantial doubt about an entity's ability to continue as a going concern. ASU 2014-15 was adopted by the Company effective December 31, 2016 and these financial statements disclose management's conclusion with respect to substantial uncertainty about the Company's ability to continue as a going concern for twelve months from the date these financial statements are issued.

In July 2015, FASB issued ASU 2015-11, Inventory regarding ASC Topic 330, *Simplifying the Measurement of Inventory*. Topic 330 currently requires an entity to measure inventory at the lower of cost or market, where market could be replacement cost, net realizable value, or net realizable value less an approximately normal profit margin. This ASU limits the scope to inventory that is measured using first-in, first-out (FIFO) or average cost and requires inventory be measured at the lower of cost or net realizable value. The new standard is effective for fiscal years beginning after December 15, 2016 and interim periods within fiscal years beginning after December 15, 2017. Management is currently evaluating the accounting, transition and disclosure requirements of the standard to determine the financial statement impact of adoption.

**1. Business and Significant Accounting Policies (continued)**

*Recent Accounting Pronouncements (continued)*

In February 2016, the FASB issued ASU 2016-02, *Leases*, which requires lessees to recognize "right of use" assets and liabilities for all leases with terms of more than 12 months. The ASU requires additional quantitative and qualitative financial statement note disclosures about the leases, significant judgments made in accounting for those leases and amounts recognized in the financial statements about those leases. The guidance will be effective for the Company in 2020 with early adoption permitted. Management is evaluating the impact that adopting this guidance will have on the financial statements.

In March 2016, the FASB issued ASU No. 2016-09, *Compensation - Stock Compensation (Topic 718)*. The new standard requires income tax effects of stock compensation awards to be recognized in the income statement when the awards vest or are settled. The new standard also allows the Company to repurchase more of an employee's shares for tax withholding purposes without triggering liability accounting and to make a policy election to account for forfeitures as they occur. The new standard is effective for annual periods beginning after December 15, 2017, and early adoption is permitted. The Company is currently evaluating the impact of ASU 2016-09 on its financial statements. Management does not believe that any other recently issued, but not yet effective, accounting pronouncements, if adopted, would have a material effect on the accompanying financial statements.

**2. Inventories**

Inventories, net consisted of the following at December 31:

| | | 2016 |
|---|---|---|
| Raw materials | $ | 440,652 |
| Work-in-progress | | 310,007 |
| Finished goods | | 683,970 |
| | | 1,434,628 |
| Provision for obsolete inventories | | (140,920) |
| | $ | 1,293,708 |

**3. Property and Equipment**

Property and equipment, net consisted of the following at December 31:





| | | 2016 |
|---|---|---|
| Furniture and fixtures | $ | 96,306 |
| Office equipment and trade booths | | 467,237 |
| Lab equipment | | 440,968 |
| Leasehold improvements | | 466,338 |
| Construction in progress | | 9,882 |
| | | 1,480,731 |
| Less accumulated depreciation and amortization | | (1,150,999) |
| Property and equipment, net | $ | 329,732 |

Depreciation and amortization expense for the year ended December 31, 2016 was $243,292.

**4. Notes Payable and Warrants Issued to Bank**

<u>February 2013 Debt Financing</u>

In February 2013, the Company signed a loan and security agreement with a bank. In connection with the agreement, the Company issued warrants to purchase 243,902 shares (the "Initial Shares") of the Company's Series C Preferred Stock at a purchase price of $0.82 per share. The fair value of the Initial Shares was determined by using the Black-Scholes option-pricing model, with the following assumptions: (i) no expected dividends; (ii) a risk-free interest rate of 1.38%; (iii) expected volatility of 53.0%; and (iv) an expected life of the warrants of seven years. The fair value of the Initial Shares was capitalized as loan issue costs of $107,986 and is amortized to interest expense over the term of the loan on a straight-line method. The issued warrants expire on February 12, 2020, subject to automatic exercise upon expiration. At December 31, 2016 there were 243,902 warrants fully-vested and outstanding, recorded as a liability with a fair value of $96,311.

In addition to the Initial Shares granted to the bank, on March 27, 2014, the Company issued to the bank warrants to purchase an additional 121,951 shares (the "Tranche B Shares") of the Company's Series C Preferred Stock at a purchase price of $0.82 per share. The fair value of the Tranche B Shares was determined by using the Black-Scholes option-pricing model, with the following assumptions: (i) no expected dividends; (ii) a risk-free interest rate of 1.38%; (iii) expected volatility of 55.0%; and (iv) an expected life of the warrants of 7.0 years. The fair value of the Tranche B Shares was recorded as a debt discount of $65,347 and is amortized to interest expense over the term of the loan using the straight-line method. The issued warrants expire on February 12, 2020, subject to automatic exercise upon expiration. At December 31, 2016 there were 121,951 warrants fully-vested and outstanding, recorded as a liability with a fair value of $53,991.





**4. Notes Payable and Warrants Issued to Bank (continued)**

March 2015 Debt Financing

In March 2015, the Company signed a loan and security agreement ("Loan Agreement") with two co-lenders. Under the terms of the Loan Agreement, the Company borrowed $7,000,000 on March 31, 2015. Under the terms of the Loan Agreement, the Company shall make monthly payments of interest only commencing on the funding date and continuing up to the amortization date, which was November 1, 2016. Beginning on the amortization date, the Company shall make equal monthly payments of principal plus interest over a period of thirty months. The principal amount outstanding shall accrue interest at a floating per annum rate equal to the greater of 8.15% or the sum of the three month LIBOR rate plus 7.89% (8.56% at December 31, 2016). All unpaid principal and accrued interest is due and payable by April 1, 2019.

In addition to the above principal and interest payments, a final payment equal to 5.25% percent of the initial principal balance is due upon termination of the loan ("Final Payment"). The Final Payment is $367,500 and was accrued at the commencement of the Loan Agreement with an offsetting accrual to unamortized debt discount. The Final Payment is being amortized to interest expense, on straight-line basis, over the term of the Loan Agreement. During 2016, $91,875 was amortized and included in interest expense in the statement of operations and comprehensive loss. At December 31, 2016, the Final Payment, net of unamortized debt discount of $206,723, is $160,777 and is recorded and included in Notes Payable. The loan is collateralized by certain assets of the Company.

In connection with the above Loan Agreement, the Company issued warrants to purchase 426,830 shares of the Company's Series C Preferred Stock at a purchase price of $0.82 per share. The fair value of the warrants was determined by using the Black-Scholes option-pricing model, with the following assumptions: (i) no expected dividends; (ii) a risk-free interest rate of 1.94%; (iii) expected volatility of 52.5%; and (iv) an expected life of the warrants of ten years. The fair value of the warrants was recorded as loan issue costs of $257,200 and is amortized to interest expense over the term of the loan using the straight-line method. The issued warrants expire on March 31, 2025, subject to automatic exercise upon expiration if they meet certain contingencies. At December 31, 2016, there were 426,830 warrants fully-vested and outstanding, recorded as a liability with a fair value of $249,183.

The aggregate annual maturities of the note payable are as follows:





| Year Ending December 31, | | |
|---|---|---|
| 2017 | | 2,800,000 |
| 2018 | | 2,800,000 |
| 2019 | | 933,333 |
| | $ | 6,533,333 |

**5. Convertible Promissory Notes and Warrants**

*Convertible Promissory Notes and Warrants Issued in 2014 and 2015*

In June 2014, the Company entered into a Note and Warrant Purchase Agreement (the "Purchase Agreement") whereby convertible promissory notes (the "Notes" or "Note") and warrants to purchase Series C preferred stock (the "Warrants") were issued to certain stockholders in exchange for cash ("Initial Closing"). The Notes issued in the Initial Closing have an aggregate principal amount of $4,000,000. In December 2014, the Purchase Agreement was amended whereby additional Notes in the aggregate principal amount of $1,250,000 and Warrants were issued to certain stockholders in exchange for cash ("Second Closing"). In January 2015, the Purchase Agreement was amended whereby additional Notes in the aggregate principal amount of $1,500,000 and Warrants were issued to certain stockholders in exchange for cash ("Third Closing"). In March 2015, the Purchase Agreement was amended whereby additional Notes in the aggregate principal amount of $2,000,000 and Warrants were issued to certain stockholders in exchange for cash ("Fourth Closing").

The Notes accrued interest at a rate of 8% per annum on the outstanding principal balance. In August 2015, the Company entered into a stock purchase agreement whereby an aggregate amount of 8,309,122 shares of Series D Convertible Preferred Stock were issued in exchange for conversion of the Indebtedness to the Note holders totaling $9,341,945.

In connection with the Notes issued under the Purchase Agreement (as amended), the Company issued Warrants to the Note holders to purchase 1,219,510, 381,093, 457,314 and 609,754 shares of the Company's Series C Preferred Stock on the First, Second, Third and Fourth Closings, respectively. The Warrants have an exercise price of $0.82 per share. The Warrants were fully exercisable on the date of issuance and expire ten years from the issuance date.

The fair value of the Warrants as of the issuance date was $768,497, $240,153, $274,693 and $366,258 for the Warrants issued on the First, Second, Third and Fourth Closings, respectively. The fair value was determined using the Black-Scholes option-pricing model with the following assumptions:

| | |
|---|---|
| Expected volatility | 52.5%-55.0% |
| Dividend yield | 0% |
| Risk-free interest rates | 1.83% to 2.59% |
| Expected term | 10 Years |

The fair value of the Warrants is presented as a debt discount on the Notes and amortized to interest expense over the term of the related Notes using the effective interest method and as a liability on the accompanying balance sheet, which is revalued at each reporting period until the warrants are exercised or expire. As of December 31, 2016, the warrants are recorded as a liability with a fair value of $1,516,787.

**6. Stockholders' Equity**

*Preferred Stock*

The Company has authorized 71,152,828 shares of Preferred Stock with a par value of $0.0001. The Preferred Stock is divided into series. The first series consists of 500,000 authorized shares and is designated Series S Convertible Preferred Stock. The second series consists of 4,687,500 authorized shares and is designated Series A Convertible Preferred Stock. The third series consists of 6,250,000 authorized shares and is designated Series B Convertible Preferred Stock. The fourth series consists of 25,916,528 authorized shares and is designated Series C Convertible Preferred Stock. The fifth series consists of 33,798,800 authorized shares and is designated Series D Convertible Preferred Stock.

*Series D Convertible Preferred Stock*

In August 2015, the Company entered into a stock purchase agreement whereby an aggregate amount of 25,489,678 shares of Series D Convertible Preferred Stock were issued in exchange for $28,658,047 in cash (gross). Additionally, 8,309,122 shares of Series D Convertible Preferred Stock were issued in August 2015 in exchange for conversion of Indebtedness to stockholders totaling $9,341,945 (Note 5).





**6. Stockholders' Equity (continued)**

*Series D Convertible Preferred Stock (continued)*

The Series D Convertible Preferred Stock contains a liquidation preference described below. Shares of Series D Convertible Preferred Stock are convertible at the holder's option into shares of common stock, initially on a share-for-share basis using a conversion rate of $1.12 per share. The conversion ratio may be adjusted upon certain events and for certain dilutive issuances, splits and combinations. Conversion is automatic in the event of a public offering of the Company's common stock meeting certain specified criteria or upon the election of 67% of the holders of the Series D Preferred Stock, Series C Preferred Stock, Series B Preferred Stock, Series A Preferred Stock and Series S Preferred Stock, voting together as a single class.

Dividends, if declared or upon the liquidation or winding up of the Company, are non-cumulative and are payable at the rate of 8% of the Series D Preferred Stock's original issue price per annum on each share. No dividends have been declared through December 31, 2016. Each share of Series D Preferred Stock has voting rights equal to the number of shares of common stock into which it is then convertible. Shares of the Series D Preferred Stock are not redeemable.

In the event that the Company has an unrestricted cash position of less than $5,000,000 or the Board of Directors determines the Company must raise additional equity capital, other than an initial public offering, then each Investor holding shares of Series D Preferred Stock shall have the right to purchase a pro rata share of additional Series D Preferred Stock at the purchase price of $1.1243 per share (as adjusted for any stock dividends, contributions, splits, recapitalizations and the like with respect to such shares). The amount of capital to be raised under these circumstances shall be the greater of $15,000,000 in net cash proceeds or an amount determined by the Board of Directors.

*Series C Convertible Preferred Stock*

In October 2012, the Company entered into a stock purchase agreement whereby an aggregate amount of 9,859,756 shares of Series C Convertible Preferred Stock were issued in two closings (October 2012 and December 2012) in exchange for $8,085,001 in cash. Additionally, 3,747,141 shares of Series C Convertible Preferred Stock were issued in October 2012 in exchange for conversion of indebtedness to stockholders totaling $3,072,656. As a result of the indebtedness' beneficial conversion feature, the Company recognized additional interest expense of $341,406 in 2012 and issued 416,349 shares of Series C Preferred Stock. Related issuance costs aggregated $91,422.

**6. Stockholders' Equity (continued)**

In March 2013, the Company completed the final closing of the Series C Preferred Stock purchase agreement whereby an aggregate amount of 8,432,928 shares of Series C Convertible Preferred Stock was issued in exchange for $6,915,001 in cash. Related issuance costs aggregated $17,842.

The Series C Convertible Preferred Stock contains a liquidation preference described below. Shares of Series C Convertible Preferred Stock are convertible at the holder's option into shares of common stock, initially on a share-for-share basis using a conversion rate of $0.82 per share. The conversion ratio may be adjusted upon certain events and for certain dilutive issuances, splits and combinations. Conversion is automatic in the event of a public offering of the Company's common stock meeting certain specified criteria or upon the election of 67% of the holders of the Series D Preferred Stock, Series C Preferred Stock, Series B Preferred Stock, Series A Preferred Stock and Series S Preferred Stock, voting together as a single class.

Dividends, if declared or upon the liquidation or winding up of the Company, are non-cumulative and are payable at the rate of 8% of the Series C Preferred Stock's original issue price per annum on each share. No dividends have been declared through December 31, 2016. Each share of Series C Preferred Stock has voting rights equal to the number of shares of common stock into which it is then convertible. Shares of the Series C Preferred Stock are not redeemable.

*Series B Convertible Preferred Stock*

In October 2008, the Company entered into a stock purchase agreement whereby an aggregate amount of 6,250,000 shares of Series B Convertible Preferred Stock were issued in exchange for $20,000,000 in cash. Related issuance costs aggregated $120,767.

The Series B Convertible Preferred Stock contains a liquidation preference described below. Shares of Series B Convertible Preferred Stock are convertible at the holder's option into shares of common stock on a share-for-share basis using a conversion rate of $1.59 per share. The conversion ratio may be adjusted upon certain events and for certain dilutive issuances, splits and combinations. Conversion is automatic in the event of a public offering of the Company's common stock meeting certain specified criteria or upon the election of 67% of the holders of the Series D Preferred Stock, Series C Preferred Stock, Series B Preferred Stock, Series A Preferred Stock and Series S Preferred Stock, voting together as a single class.





**6. Stockholders' Equity (continued)**

Dividends, if declared or upon the liquidation or winding up of the Company, are non-cumulative and are payable at the rate of 8% of the Series B Preferred Stock's original issue price per annum on each share. No dividends have been declared through December 31, 2016. Each share of Series B Preferred Stock has voting rights equal to the number of shares of common stock into which it is then convertible. Shares of the Series B Preferred Stock are not redeemable.

*Series A Convertible Preferred Stock*

In May 2006, the Company entered into a stock purchase agreement whereby an aggregate amount of 2,812,500 shares of Series A Convertible Preferred Stock were issued in exchange for $4,500,000 in cash. Related issuance costs aggregated $73,932.

In August 2007, the Company entered into a stock purchase agreement whereby an aggregate amount of 1,875,000 shares of Series A Convertible Preferred Stock were issued in exchange for $3,000,000 in cash. Related issuance costs aggregated $22,408.

The Series A Convertible Preferred Stock contains a liquidation preference described below. Shares of Series A Convertible Preferred Stock are convertible at the holder's option into shares of common stock on a share-for-share basis using a conversion rate of $1.12 per share. The conversion ratio may be adjusted upon certain events and for certain dilutive issuances, splits and combinations. Conversion is automatic in the event of a public offering of the Company's common stock meeting certain specified criteria or upon the election of 67% of the holders of the Series D Preferred Stock, Series C Preferred Stock, Series B Preferred Stock, Series A Preferred Stock and Series S Preferred Stock, voting together as a single class.

Dividends, if declared or upon the liquidation or winding up of the Company, are non-cumulative and are payable at the rate of 8% of the Series A Preferred Stock's original issue price per annum on each share. No dividends have been declared through December 31, 2016. Each share of Series A Preferred Stock has voting rights equal to the number of shares of common stock into which it is then convertible. Shares of the Series A Preferred Stock are not redeemable.

*Series S Convertible Preferred Stock*

In September 2005, the Company entered into a stock purchase agreement whereby an aggregate amount of 500,000 shares of Series S Preferred Stock were issued in exchange for $500,000 in cash. Related issuance costs aggregated $39,998.

**6. Stockholders' Equity (continued)**

The Series S Convertible Preferred Stock contains a liquidation preference described below. Shares of Series S Convertible Preferred Stock are convertible at the holder's option into shares of common stock on a share-for-share basis using a conversion rate of $0.84 per share. The conversion ratio may be adjusted upon certain events and for certain dilutive issuances, splits and combinations. Conversion is automatic in the event of a public offering of the Company's common stock meeting certain specified criteria or upon the election of 67% of the holders of the Series C Preferred Stock, Series B Preferred Stock, Series A Preferred Stock and Series S Preferred Stock, voting together as a single class.

Dividends, if declared or upon the liquidation or winding up of the Company, are non-cumulative and are payable at the rate of 8% of the Series S Preferred Stock's original issue price per annum on each share. No dividends have been declared through December 31, 2016. Each share of Series S Preferred Stock has voting rights equal to the number of shares of common stock into which it is then convertible. Shares of the Series S Preferred Stock are not redeemable.

*Liquidation Preferences*

Upon liquidation, dissolution or winding up of the Company, the holders of Series D Preferred Stock, on a pro rata basis, are entitled to receive, prior and in preference to any distribution from the assets of the Company to the holders of all other series of Preferred Stock and the holders of common stock, an amount per share equal to the original issue price of the Series D Preferred Stock, plus all declared but unpaid dividends.

After payment of the above amounts, the holders of the Series S Preferred Stock, Series A Preferred Stock, Series B Preferred Stock and Series C Preferred Stock, on a pro rata basis, are entitled to receive, prior and in preference to any distribution from the assets of the Company to the holders of common stock, an amount per share equal to the original issue price of the Series S Preferred Stock, Series A Preferred Stock, Series B Preferred Stock and Series C Preferred Stock, plus all declared but unpaid dividends.

After payment of the above amounts, the remaining assets of the Company available for distribution to the stockholders shall be distributed to the holders of the common stock.





**6. Stockholders' Equity (continued)**

*Common Stock*

The Company has authorized 105,000,000 shares of common stock with a par value of $0.0001.

In August 2005, the Company issued 1,625,000 shares of its common stock to founders in exchange for cash totaling $1,625.

In 2008, the Company issued 375,000 shares of the Company's common stock to consultants, subject to the terms of the 2005 Stock Incentive Plan and Restricted Stock Award Agreements as consideration for services provided. The aggregate value of the shares at issuance was as follows:

| | Number of Shares | Value per Share | Aggregate Value of Shares |
|---|---|---|---|
| January 2008 | 250,000 | $ 0.25 | $ 62,500 |
| July 2008 | 87,500 | $ 0.25 | $ 21,875 |
| November 2008 | 37,500 | $ 0.48 | $ 18,000 |

The Company has a right of first refusal to purchase all or any shares offered for sale at the price specified in the offer. The rights provided the Company shall terminate upon the consummation of a public offering or immediately prior to the consummation of a change in control whereupon the shares will be exchanged for shares of a successor corporation, which corporation is publicly held.

In 2008, the Company issued 400,000 shares of the Company's common stock to a key employee, subject to the terms of the 2005 Stock Incentive Plan and a Restricted Stock Purchase Agreement in exchange for cash of $100,000. The restricted stock is subject to a right of first refusal as defined in the Restricted Stock Purchase Agreement.

During the year ended December 31, 2016, 113,624 shares of common stock were issued in exchange for cash of $24,469 upon the exercise of options.

*Warrants*

In November 2011, the Company issued warrants to an outside consultant to purchase 26,533 shares of the Company's common stock at a per share price of $0.44 in exchange for services. The warrants expire on November 22, 2021 and as of December 31, 2016 all the warrants are fully-vested and outstanding.

In August 2013, the Company issued warrants to an outside consultant to purchase 36,836 shares of the Company's common stock at a per share price of $0.18 in exchange for services. The warrants expire on August 22, 2023 and as of December 31, 2016 all the warrants are fully-vested and outstanding.





Common shares reserved for future issuance consisted of the following at December 31, 2016:

| | |
|---|---|
| Conversion of preferred stock | 75,708,910 |
| Stock warrants outstanding | 3,523,723 |
| Stock options issued and outstanding | 18,300,934 |
| Authorized for future stock option grants | 2,489,166 |
| Total | 100,022,733 |

## 7. Stock Options

The Company adopted the 2015 Stock Incentive Plan (the "2015 Plan") on October 26, 2015, which provides for the issuance of shares of the Company's common stock to employees, directors and consultants. The exercise price of options granted under the 2015 Plan is established by the Company's Board of Directors and no option shall have a term in excess of ten years from the option grant date. Options vest in various installments as outlined in the related stock option agreements, or as determined by the Company's Board of Directors. The 2015 Plan supersedes the previous 2005 Stock Incentive Plan (the "2005 Plan") under which options were issued through October 25, 2015. Shares of common stock authorized for issuance under the 2015 Plan, include any shares outstanding on October 25, 2015 under the 2005 Plan, that are subsequently cancelled or expired under their normal terms.

As of December 31, 2016, the Company has reserved up to 21,805,357 shares of its common stock, consisting of 8,293,315 shares related to outstanding options granted under the 2005 Plan and 13,512,042 shares authorized, as described above, under the 2015 Plan





## 7. Stock Options (continued)

to provide for the issuance of shares of the Company's common stock to employees, directors and consultants under its stock option plan.

In 2016 the Company granted 9,214,009 of options to its employees. During the year ended December 31, 2016 the Company recorded stock-based employee compensation expense of $293,766. Stock-based employee compensation expense was determined using the fair value of stock options as of the grant date.

In 2016 the Company granted 1,517,657 of options to non-employees in exchange for services. During the year ended December 31, 2016 the Company recorded stock-based compensation expense to non-employees of $79,298 in connection with non-employee options earned.

The fair value of each option grant was estimated using the Black-Scholes option pricing model with the following assumptions:

| | 2016 |
|---|---|
| Expected volatility | 51.90% |
| Dividend yield | 0% |
| Risk-free interest rates | 1.0% to 2.4% |
| Expected term - non-employees | 5.5 years |
| Expected term - employees | 10 years |

The weighted average grant date fair value of all stock options granted during the year ended December 31, 2016 is $0.17.

*Stock Option Activity*

A summary of stock option activity in 2016 is as follows:

| | Number of Options Outstanding | Weighted Average Exercise Price |
|---|---|---|
| Balance, December 31, 2015 | 11,337,089 | $ 0.233 |
| Granted | 10,731,666 | 0.359 |
| Cancelled/expired | (3,654,197) | 0.319 |

| | | |
|---|---|---|
| Exercised | (113,624) | 0.215 |
| Balance, December 31, 2016 | 18,300,934 | $ 0.310 |

The intrinsic value of options exercised during 2016 was $14,163.





**7. Stock Options (continued)**

The following table summarizes information concerning outstanding, vested, expected to vest and exercisable stock options at December 31, 2016:

| | Options | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (Years) |
|---|---|---|---|
| Outstanding | 18,300,934 | $ 0.31 | 8.0 |
| Exercisable | 8,560,502 | $ 0.26 | 6.0 |
| Vested and expected to vest | 17,278,639 | $ 0.31 | 6.3 |

As of December 31, 2016 total compensation cost related to nonvested options not yet recognized is $1,380,384, and the weighted average period over which this amount is expected to be recognized is 3.5 years.

**8. Commitments and Contingencies**

*Operating Leases*

In December 2016, the Company approved a plan for the early termination and exit of the operating lease for its existing headquarter office location in San Clemente, California. As part of the plan to exit the lease, the Company recognized a charge in the amount of $674,025 related to the impairment of leasehold improvements, certain remaining minimum lease payments and lease termination expenses. The amount is shown as impairment charge and lease termination charges in the statement of operations and comprehensive loss.

In January 2017, the Company entered into an operating lease for a facility to serve as its new headquarter office in a separate location of San Clemente, California. The lease commences on April 1, 2017 and expires on June 30, 2022.

In January 2017, the Company extended an operating lease for its manufacturing facility. The extension was to a prior lease on the same property dated October 12, 2015. The January 2017 lease amendment extended the terms of the lease through October 31, 2019.





**8. Commitments and Contingencies (continued)**

*Operating Leases (continued)*

Future minimum lease payments required under these leases are as follows for the years ending December 31:

| | |
|---|---|
| 2017 | $ 414,086 |
| 2018 | 431,624 |
| 2019 | 419,082 |
| 2020 | 319,262 |
| 2021 | 327,949 |
| 2022 | 165,061 |
| | $ 2,077,063 |

Rent expense for the years ended December 31, 2016 was $605,693.

*Litigation*

On April 20, 2017, a company filed a Complaint in Federal Court in the District of Delaware accusing ReShape Medical, Inc. of trade secret misappropriation under the California Uniform Trade Secrets Act (CA. Civ. Code §3426 et seq.) and/or Delaware law (Code Ann. Title 6 §2001 et seq); and infringement of U.S. Patent Nos. 9,445,930 and 9,456,915. Management of the Company intends to vigorously defend against the claims and believes the risk of loss remote.

From time to time, the Company may be involved in certain legal matters which arise in the normal course of operations. Management believes that the resolution of such matters will not have a material adverse effect on the financial position or results of operations of the Company.

**9. Related Party Transactions**

The Company is a party to consulting agreements with two members of its Board of Directors. The agreements provide for fees to be paid in exchange for business strategy, regulatory and product development advisory services. In 2016, the Company issued payments to the board members in the combined amount of $195,637 in exchange for these services.





**9. Related Party Transactions (continued)**

*Indemnities*

During the normal course of business, the Company has made certain indemnities under which it may be required to make payments in relation to certain transactions. These indemnities include (i) certain real estate leases, under which the Company may be required to indemnify property owners for general liabilities; and (ii) certain agreements with the Company's officers and directors, under which the Company may be required to indemnify such persons for liabilities arising out of their employment relationship and (iii) certain agreements with customers, under which the Company may be required to indemnify the customer for product related liabilities. The duration of these indemnities do not provide for any limitation of the maximum potential future payments that Company could be obligated to make. Historically, the Company has not been obligated to make significant payments for these obligations and no liabilities have been recorded for these indemnities in the accompanying balance sheet.

**10. Income Taxes**

The tax effects of temporary differences that give rise to significant portions of the net deferred tax assets are as follows as of December 31, 2016:

| | | 2016 |
|---|---|---|
| Net operating loss carryforwards | $ | 31,135,000 |
| Research credits and other state credits | | 724,000 |
| Depreciation and amortization | | 2,357,000 |
| Stock-based compensation | | 149,000 |
| Other | | 368,000 |
| Prepaids | | (43,000) |
| | | 34,690,000 |
| Valuation allowance | | (34,690,000) |
| | $ | — |

Management has established a 100% valuation allowance for the Company's net deferred tax assets due to the uncertainty that the deferred tax assets will be realized by the Company's ability to generate sufficient future taxable income.

At December 31, 2016, the Company had approximately $80,466,000 and $77,282,000 of net operating loss carryforwards for federal and state purposes, respectively, available to offset future taxable income. Federal net operating losses can be carried back for two years, and remaining, unused carrybacks can be carried forward 20 years. Net operating losses begin to expire in 2026 and 2016 for federal and state tax purposes, respectively.

Utilization of the Company's net operating losses in future periods may be limited by Section 382 of the Internal Revenue Code due to changes in the Company's ownership structure, the effects of which have not been determined.





**10. Income Taxes (continued)**

At December 31, 2016, the Company had federal and state research and development credit carryforwards of $977,000 and $715,000, respectively, which begin to expire in 2026 for federal purposes and carry over indefinitely for state purposes. In addition, the Company had related unrecognized tax benefits for federal and state of $488,000 and $357,000 respectively. None of the unrecognized tax benefits, if recognized, would impact the annual effective tax rate, due to the valuation allowance. The Company's unrecognized tax benefits are recorded as a reduction in deferred tax assets. The Company does not expect any significant increases or decreases to the Company's unrecognized tax benefits within the next 12 months. The Company is subject to U.S. federal tax authority examinations and U.S. state tax authority examinations for all years with the net operating loss and credit carryforwards. The Company has not accrued for interest or penalties associated with unrecognized tax liabilities.

In November 2015, the FASB issued ASU No. 2015-17, "Income Taxes, Balance Sheet Classification of Deferred Taxes" which requires all deferred tax assets and liabilities be classified as non-current on the balance sheet instead of separating deferred taxes into current and non-current amounts. In addition, valuation allowance allocations between current and non-current tax assets are no longer required because those allowances also will be classified as non-current. The guidance is effective for annual periods beginning after December 31, 2016, and interim periods therein. The Company early adopted this standard for the December 31, 2016 financial statements on a prospective basis and this standard did not have a material impact on its' financial statements.

The reconciliation between the Company's effective tax rate on loss from continuing operations and the statutory tax rate, for the year ended December 31, 2016 is as follows:

| | |
|---|---|
| Income tax benefit at federal statutory rates | 34.00% |
| State and local income taxes net of federal tax benefit | (0.01)% |
| Meals and entertainment expense | (0.12)% |
| Employee stock based compensation | (0.69)% |
| Tax credits | (2.03)% |
| Valuation allowance | (31.16)% |
| Effective tax rate | (0.01)% |





## 11. Subsequent Events

The Company has evaluated subsequent events through May 25, 2017, which is the date the financial statements are available for issuance, and concluded that there were no events or transactions that need to be disclosed other than those disclosed throughout these financial statements.

**Exhibit 99.2**

*Financial Statements and Independent Auditors' Report*

*As of December 31, 2015 and for the Year Then Ended*

**RESHAPE MEDICAL, INC.**

**Table of Contents**



## INDEPENDENT AUDITORS' REPORT

To the Board of Directors
ReShape Medical, Inc.

We have audited the accompanying financial statements of ReShape Medical, Inc. (the "Company"), which comprise the balance sheet as of December 31, 2015, and the related statements of operations, stockholders' equity (deficit), and cash flows for the year then ended, and the related notes to 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.

**Auditors' Responsibility**

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

INDEPENDENT AUDITORS' REPORT (CONTINUED)

**Opinion**

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

**Emphasis of Matter - Restatement**

As discussed in Note 1 to the financial statements, the 2015 financial statements have been restated to correct a misstatement related to the classification of certain warrants. Our opinion is not modified with respect to this matter.

/s/ HASKELL & WHITE LLP

Irvine, California
May 26, 2016, except for the restatement discussed in Note 1, for the which the date is December 15, 2017

---

**RESHAPE MEDICAL, INC.**

**Balance Sheet**

| | December 31, 2015 (Restated) |
|---|---|
| **Assets** | |
| **Current assets** | |
| Cash and cash equivalents | $ 10,375,143 |
| Short-term investments | 11,910,005 |
| Accounts receivable, net | 248,614 |
| Inventories, net (Note 2) | 1,354,057 |
| Prepaid expenses and other current assets | 139,006 |
| Total current assets | 24,026,825 |
| **Property and equipment, net** (Note 3) | 648,811 |
| **Other assets** | 105,830 |
| Total assets | $ 24,781,466 |
| **Liabilities and Stockholders' Equity (Deficit)** | |
| **Current liabilities** | |
| Accounts payable | $ 465,150 |
| Current portion of notes payable | 421,449 |
| Payroll-related liabilities | 962,602 |
| Accrued and other liabilities | 742,918 |
| Total current liabilities | 2,592,119 |
| **Long-term liabilities** | |
| Notes payable, less current portion and unamortized debt discount of $368,458 (Note 4) | 6,210,092 |
| Final payment liability, less unamortized debt discount of $298,596 (Note 4) | 68,904 |
| Warrant liabilities (Note 1) | 1,939,781 |
| Total liabilities | 10,810,896 |

See accompanying notes to financial statements and independent auditors' report.



---

**RESHAPE MEDICAL, INC.**

**Balance Sheet (continued)**

| | December 31, 2015 (Restated) |
|---|---|
| **Commitments and contingencies** (Note 8) | |
| **Stockholders' equity (deficit)** (Notes 6 and 7) | |

| | | |
|---|---|---|
| Series D Convertible Preferred Stock, $.0001 par value; 33,798,800 shares authorized; 33,798,800 shares issued and outstanding; liquidation preference of $38,000,000 | | 3,380 |
| Series C Convertible Preferred Stock, $.0001 par value; 25,916,528 and 25,609,756 shares authorized at December 31, 2015 22,456,174 shares issued and outstanding at December 31, 2015 liquidation preference of $18,414,063 | | 2,246 |
| Series B Convertible Preferred Stock, $.0001 par value; 6,250,000 shares authorized; 6,250,000 shares issued and outstanding; liquidation preference of $20,000,000 | | 625 |
| Series A Convertible Preferred Stock, $.0001 par value; 4,687,500 and 4,737,500 shares authorized at December 31, 2015 4,687,500 shares issued and outstanding at December 31, 2015 liquidation preference of $7,500,000 | | 469 |
| Series S Convertible Preferred Stock, $.0001 par value; 500,000 shares authorized; 500,000 shares issued and outstanding; liquidation preference of $500,000 | | 50 |
| Common Stock, $.0001 par value; 100,000,000 and 56,972,387 shares authorized at December 31, 2015; 2,526,633 and 2,514,633 shares issued and outstanding at December 31, 2015 | | 253 |
| Additional paid in capital | | 85,060,237 |
| Accumulated other comprehensive (loss) | | (21,933) |
| Accumulated (deficit) | | (71,074,757) |
| Total stockholders' equity (deficit) | | 13,970,570 |
| Total liabilities and stockholders' equity (deficit) | $ | 24,781,466 |

See accompanying notes to financial statements and independent auditors' report.



## RESHAPE MEDICAL, INC.

### Statement of Operations

| | | Year Ended December 31, 2015 (Restated) |
|---|---|---|
| **Revenues** | $ | 649,027 |
| **Cost of goods sold** | | 2,005,442 |
| Gross margin | | (1,356,415) |
| **Operating expenses** | | |
| Selling, general and administrative | | 6,831,104 |
| Regulatory and clinical | | 1,770,268 |
| Research and development | | 1,292,516 |
| Total operating expenses | | 9,893,888 |
| Loss from operations | | (11,250,303) |
| **Other income (expense)** | | |
| Interest expense, net (Notes 4 and 5) | | (2,408,900) |
| Other (expense) income, net | | (7,088) |
| Revaluation of warrant liabilities | | 84,570 |
| Total other expense | | (2,331,418) |
| Loss before income taxes | | (13,581,721) |
| **Provision for income taxes** | | (17,681) |
| Net loss | | (13,599,402) |
| **Other comprehensive loss, net of tax** | | |
| Net unrealized loss on short-term investments | | (21,933) |
| Comprehensive loss | $ | (13,621,335) |

See accompanying notes to financial statements and independent auditors' report.



## RESHAPE MEDICAL, INC.

### Statement of Stockholders' Equity (Deficit) - Restated
### For the Year Ended December 31, 2015

Accumulated

| | Series D Preferred Stock Shares | Series D Preferred Stock Amount | Series C Preferred Stock Shares | Series C Preferred Stock Amount | Series B Preferred Stock Shares | Series B Preferred Stock Amount | Series A Preferred Stock Shares | Series A Preferred Stock Amount | Series S Preferred Stock Shares | Series S Preferred Stock Amount | Common Stock Shares | Common Stock Amount | Additional Paid in Capital | Other Comprehensive (Loss) | Accumulated Deficit | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Balance, December 31, 2014** | — | — | 22,456,174 | 2,246 | 6,250,000 | 625 | 4,687,500 | 469 | 500,000 | 50 | 2,514,633 | 251 | 47,250,559 | — | (57,475,355) | (10,221,155) |
| Series D convertible preferred stock issued for cash, net of issuance costs of $359,124 | 25,489,678 | 2,549 | — | — | — | — | — | — | — | — | — | — | 28,296,374 | — | — | 28,298,923 |
| Series D convertible preferred stock converted from notes payable | 8,309,122 | 831 | — | — | — | — | — | — | — | — | — | — | 9,341,114 | — | — | 9,341,945 |
| Exercise of options | — | — | — | — | — | — | — | — | — | — | 12,000 | 2 | 2,998 | — | — | 3,000 |
| Stock-based compensation | — | — | — | — | — | — | — | — | — | — | — | — | 169,192 | — | — | 169,192 |
| Net unrealized loss on short-term investments | — | — | — | — | — | — | — | — | — | — | — | — | — | (21,933) | — | (21,933) |
| Net loss for the year ended December 31, 2015 | — | — | — | — | — | — | — | — | — | — | — | — | — | — | (13,599,402) | (13,599,402) |
| **Balance, December 31, 2015** | 33,798,800 | $ 3,380 | 22,456,174 | $ 2,246 | 6,250,000 | $ 625 | 4,687,500 | $ 469 | 500,000 | $ 50 | 2,526,633 | $ 253 | $ 85,060,237 | $ (21,933) | $ (71,074,757) | $ 13,970,570 |

See accompanying notes to financial statements and independent auditors' report.



## RESHAPE MEDICAL, INC.

### Statement of Cash Flows

| | Year Ended December 31, 2015 (Restated) |
|---|---|
| **Cash flows from operating activities** | |
| Net loss | **$ (13,599,402)** |
| Adjustments to reconcile net loss to net cash used in operating activities: | |
| Depreciation expense | **105,154** |
| Stock-based compensation | **169,192** |
| Amortization of debt issue costs | **2,216,501** |
| Provision for obsolete inventories | **20,507** |
| Revaluation of warrant liabilities | **(84,570)** |
| Increase (decrease) from changes in: | |
| Accounts receivable | **(232,080)** |
| Inventories | **(1,063,032)** |
| Prepaid expenses and other assets | **(214,247)** |
| Accounts payable | **(952,963)** |
| Payroll-related liabilities | **518,369** |
| Accrued and other liabilities | **291,369** |
| Final payment liability to bank | **68,904** |
| Net cash used in operating activities | **(12,756,298)** |
| **Cash flows from investing activities** | |
| Net purchases of short-term investments | **(11,931,938)** |
| Acquisition of property and equipment | **(632,143)** |
| Net cash used in investing activities | **(12,564,081)** |
| **Cash flows from financing activities** | |
| Proceeds from issuance of convertible notes payable | **3,500,000** |
| Proceeds from issuance of note payable to bank | **7,000,000** |
| Debt issue costs on note payable to bank | **(368,458)** |
| Principal payments on note payable to bank | **(3,757,450)** |
| Proceeds from the exercise of warrants | **33** |
| Proceeds from the issuance of Series D preferred stock | **28,658,047** |

| | |
|---|---|
| Proceeds from the exercise of options | 3,000 |
| Equity offering costs | (310,469) |
| | |
| Net cash provided by financing activities | 34,724,703 |
| | |
| **Net increase in cash and cash equivalents** | **9,404,324** |
| | |
| **Cash and cash equivalents, beginning of the year** | **970,819** |
| | |
| **Cash and cash equivalents, end of year** | **$ 10,375,143** |

See accompanying notes to financial statements and independent auditors' report.



**RESHAPE MEDICAL, INC.**

**Statement of Cash Flows (continued)**

| | Year Ended December 31, 2015 (Restated) |
|---|---|
| **Supplemental disclosures of cash flow information:** | |
| | |
| **Cash paid during the year for:** | |
| Interest | $ 658,408 |
| Income taxes | $ 2,752 |
| | |
| **Supplemental schedule of non-cash financing activities:** | |
| | |
| Warrants issued in connection with debt | $ 898,151 |
| Convertible notes payable debt discount amortization | $ 1,082,429 |
| Series D preferred stock issued upon conversion of indebtedness | $ 9,341,945 |
| Purchase of leasehold improvements | $ 202,127 |
| Disposals of property and equipment | $ 4,745 |
| Reclassification of debt issue costs | $ — |

See accompanying notes to financial statements and independent auditors' report.



**RESHAPE MEDICAL, INC.**

**Notes to Financial Statements**

## 1. Business and Significant Accounting Policies

*Business*

ReShape Medical, Inc. (the "Company") was originally incorporated on August 22, 2005, under the name Abdominis, Inc., pursuant to the laws of the State of Delaware. In January 2007, the Company changed its name from Abdominis, Inc. to ReShape Medical, Inc. The Company is an early-stage medical device company that has developed and is commercializing a unique non-surgical product for the treatment of obesity.

*Basis of Presentation*

The accompanying financial statements have been prepared in accordance with generally accepted accounting principles in the United States ("GAAP").

*Management Estimates*

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and the disclosure of contingent assets and liabilities, at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Management considers many factors in developing estimates and assumptions that are used in the preparation of these financial statements. Management must apply significant judgment in this process. In addition, other factors may affect estimates, including: expected business and operational changes, sensitivity and volatility associated with the assumptions used in developing estimates, and whether historical trends are expected to be representative of future trends. The estimation process often may yield a range of potentially reasonable estimates of the ultimate future outcomes and management must select an amount that falls within that range of reasonable estimates. This process may result in actual results differing from those estimated amounts used in the preparation of the financial statements.

*Cash and Cash Equivalents*

The Company considers all highly liquid investments with a maturity of three months or less, when acquired, to be cash equivalents. Substantially all of the Company's cash and cash equivalents are maintained at one financial institution domiciled in the United States. Amounts on deposit with this financial institution may, from time to time, exceed the federally-insured limit, as well as coverage provided by the Securities Investment Protection Corporation.

See accompanying independent auditors' report.





**1. Business and Significant Accounting Policies (continued)**

*Short-term Investments*

Short-term investments are comprised of commercial paper and corporate obligations with original maturity dates greater than ninety days and less than one year. The Company classifies its short-term investments as available for sale securities with net unrealized gains or losses recorded as a component of stockholders' equity (deficit).

*Accounts Receivable*

Trade accounts receivable are stated at the amount the Company expects to collect. The Company maintains allowances for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. Management considers the following factors when determining the collectability of specific customer accounts: customer credit worthiness, past transaction history with the customer, current economic industry trends, and changes in customer payment terms. If the financial condition of the Company's customers were to deteriorate, adversely affecting their ability to make payments, additional allowances would be required. Based on management's assessment, the Company provides for estimated uncollectible amounts through a charge to earnings and a credit to a valuation allowance. Balances that remain outstanding after the Company has used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to accounts receivable. There was no valuation allowance recorded as of December 31, 2015.

*Inventories*

Inventories are carried at the lower of cost, determined on a first-in, first-out ("FIFO") basis, or market.

*Property and Equipment*

Property and equipment are recorded at cost. The Company provides for depreciation over estimated useful lives of two to three years, or the life of the related lease for leasehold improvements using the straight-line method. Repairs and maintenance expenditures that do not significantly add value to property and equipment, or prolong its life, are charged to expense as incurred. Gains and losses on dispositions of property and equipment are included in the operating results of the related period.

See accompanying independent auditors' report.





**1. Business and Significant Accounting Policies (continued)**

*Impairment of Long-lived assets*

The Company will record impairment losses on long-lived assets used in operations when events and circumstances indicate that assets might be impaired and the undiscounted cash flows estimated to be generated by those assets are less than the carrying amount of those assets. An impairment analysis is subjective and assumptions regarding future growth rates and operating expense levels can have a significant impact on the expected future cash flows and impairment analysis. To date, the Company has not experienced any impairment losses on its long-lived assets used in operations. While the Company's current and historical operating losses and cash flows are indicators of impairment, the Company believes that future cash flows from operating activities and financing activities will exceed the carrying value of its long-lived assets and accordingly, the Company has not recognized any impairment losses through December 31, 2015.

*Concentrations*

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash, short-term investments and accounts receivable. The Company maintains balances that at times may exceed amounts that are federally-insured or insured by the Securities Investor Protection Corporation. Management mitigates such potential risks by maintaining the Company's cash and short-term investment balances with entities that management believes possess high-credit quality and does not anticipate any losses with regards to these amounts.

The Company had two customers that accounted for 34% and 12% of net revenues for the year ended December 31, 2015.

The Company had six customers that accounted for 21%, 20%, 14%, 12%, 11% and 11% of outstanding accounts receivable at December 31, 2015.

*Fair Value Measurements*

The Company measures fair value based on a three-level hierarchy of inputs, of which the first two are considered observable and the last unobservable. Unobservable inputs reflect the Company's own assumptions about current market conditions. The three-level hierarchy of inputs is as follows:





**1. Business and Significant Accounting Policies (continued)**

*Fair Value Measurements (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 assets or liabilities.

The fair value of the Company's financial assets and liabilities measured on a recurring basis as of December 31, 2015 , are as follows:

| | Balance as of December 31, 2015 | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs |
|---|---|---|---|---|
| Assets | | | | |
| Cash equivalents | $ 10,375,143 | $ 10,375,143 | $ — | $ — |
| Short-term investments | 11,910,005 | 11,910,005 | — | — |
| | $ 22,285,148 | $ 22,285,148 | $ — | $ — |

The fair value of the Company's cash equivalents and short-term investments were determined using Level 1 inputs. Unadjusted quoted prices for these securities are regularly provided to the Company by independent pricing services.

*Preferred Stock Warrants*

The Company has issued freestanding warrants to purchase shares of its convertible preferred stock which are accounted for as a liability due to the nature of the underlying redemption provisions of the preferred stock into which the warrants are exercisable. The warrants are recorded on the Company's balance sheet at their fair value as determined on the date of issuance and are revalued at each subsequent balance sheet date, with fair value changes recognized as other income or expense in the accompanying statement of operations and comprehensive loss. The Company will continue to adjust the liability for changes in fair value until the earlier of the exercise or expiration of the warrants, the completion of a deemed liquidation event, the conversion of convertible preferred stock into common stock, or until the holders of the convertible preferred stock can no longer trigger a deemed liquidation event. Pursuant to the terms of these warrants, upon the conversion of the class of preferred stock underlying the warrant, the warrants automatically become exercisable for shares of the Company's common stock based upon the conversion ratio of the underlying class of preferred stock. The consummation





**1. Business and Significant Accounting Policies (continued)**

*Preferred Stock Warrants (continued)*

of an initial public offering will result in the conversion of all classes of the Company's preferred stock into common stock. Upon such conversion of the underlying classes of preferred stock, the warrants will be classified as a component of equity and will no longer be subject to re-measurement. The Company estimates the fair value of the liability using option pricing models and assumptions that are based on the individual characteristics of the warrants or instruments on the valuation date, including assumptions for the estimated fair value of the underlying equity instrument, expected volatility, expected life, yield, and risk-free interest rate.

A summary of preferred stock warrant activity for the year ended December 31, 2015 is as follows:

| | Number of Shares | | Warrant Liabilities |
|---|---|---|---|
| Balance, December 31, 2014 | 1,966,456 | $ | 1,126,200 |
| | | | |
| Issuances | 1,493,898 | | 898,151 |
| Exercises | — | | — |
| Change in fair value | — | | (84,570) |
| | | | |
| Balance, December 31, 2015 | 3,460,354 | $ | 1,939,781 |

*Correction of Prior Period Accounting Errors*

Subsequent to the issuance of the Company's financial statements as of and for the year ended December 31, 2015, the Company identified an error in the previously issued financial statements.

As of December 31, 2015, the Company had outstanding warrants to purchase 3,460,354 shares of its Series C Preferred Stock. The Company's Series C Preferred Stock is contingently redeemable by the holders. Warrants for the purchase of contingently redeemable shares must be classified as liabilities and measured at fair value, with changes in fair value recognized in earnings. At their respective grant dates, the Company measured the fair value of the Series C Preferred Stock warrants using the Black-Scholes option pricing model. However, the Company recognized the grant date fair value of the warrants in additional paid-in-capital in total stockholders' equity, not as a liability. Further, the Company had not re-measured the fair value of the Series C Preferred Stock warrants since the grant date.

See accompanying independent auditors' report.





**1. Business and Significant Accounting Policies (continued)**

*Correction of Prior Period Accounting Errors (continued)*

The Company calculated the fair value of the Series C Preferred Stock warrant as of December 31, 2015 and 2014 using the Black-Scholes option pricing model. The Black-Scholes option pricing model utilizes certain key input assumptions, including the fair value of the Company's Series C Preferred Stock into which the warrant is convertible and the expected stock price volatility.

As a result of the above error, the previously issued financial statements as of and for the year ended December 31, 2015 have been adjusted and restated as follows:

| | | As Previously Reported | | Adjustment | | As Restated |
|---|---|---|---|---|---|---|
| **Effects on Balance Sheet as of December 31, 2015** | | | | | | |
| Notes payable, less current portion and unamortized debt discount | $ | 6,230,973 | $ | (20,881) | $ | 6,210,092 |
| Unamortized debt discount | | 347,577 | | 20,881 | | 368,458 |
| Warrant liabilities | | 0 | | 1,939,781 | | 1,939,781 |
| Total liabilites | | 8,891,996 | | 1,918,900 | | 10,810,896 |
| Additional paid in capital | | 86,965,837 | | (1,905,600) | | 85,060,237 |
| Accumlated (deficit) | | (71,061,457) | | (13,300) | | (71,074,757) |
| Total stockholders' equity (deficit) | | 15,889,470 | | (1,918,900) | | 13,970,570 |
| | | | | | | |
| **Effects on Statement of Operations for the year ended December 31, 2015** | | | | | | |
| | | | | | | |
| Interest expense, net | $ | (2,306,850) | $ | (102,050) | $ | (2,408,900) |
| Revaluation of warrant liabilities | | 0 | | 84,570 | | 84,570 |
| Total other expense | | (2,313,938) | | (17,480) | | (2,331,418) |
| Loss before income taxes | | (13,564,241) | | (17,480) | | (13,581,721) |
| Net loss | | (13,581,922) | | (17,480) | | (13,599,402) |
| Comprehensive loss | | (13,603,855) | | (17,480) | | (13,621,335) |
| | | | | | | |
| **Effects on Statement of Cash Flows for the year ended December 31, 2015** | | | | | | |
| | | | | | | |
| Net loss | $ | (13,581,922) | $ | (17,480) | $ | (13,599,402) |
| Amortization of debt issue costs | | 2,093,570 | | 122,931 | | 2,216,501 |
| Revaluation of warrant liabilities | | 0 | | (84,570) | | (84,570) |
| Net cash used in operating activities | | (12,777,179) | | 20,881 | | (12,756,298) |
| Debt issue costs on note payable to bank | | (347,577) | | (20,881) | | (368,458) |
| Net cash provided by financing activities | | 34,745,584 | | (20,881) | | 34,724,703 |

*Revenue Recognition*

Revenue is recognized when persuasive evidence of the arrangement exists, delivery and performance has occurred, the price is fixed and determinable and collectability is probable. Generally, these criteria are met at the time products are shipped. Provisions for discounts are recorded and are classified as reductions to revenues.





**1. Business and Significant Accounting Policies (continued)**

*Shipping and Handling*

The Company records amounts invoiced to its customers for outbound freight and shipping as revenue and the related expense as cost of goods sold.

*Warranty Accrual*

The Company's products are covered by a one year warranty policy against defective products at the time of shipment. In the event that a product is defective, the Company may replace the product or refund the purchase price or a portion thereof. The Company estimates future warranty costs by analyzing the timing, cost and amount of returned product and by considering future expectations. Assumptions and historical warranty experience are evaluated periodically to determine the continued appropriateness of such assumptions. The Company recorded a reserve for warranty claims in the amount of $37,000 as of December 31, 2015 , which is included within accrued and other liabilities on the accompanying balance sheet.

*Foreign Currency*

The Company maintains a foreign bank account for purposes of collecting trade receivables from foreign customers. Foreign bank balances are translated at the rates of exchange at the balance sheet date. Gains and losses resulting from foreign currency transactions are recorded within other income in the accompanying statements of operations.

*Patent-related Expenditures*

Expenditures related to patent research and applications, which are primarily comprised of legal fees, are expensed as incurred.

*Research and Development*

Research and development costs are expensed when incurred.

*Income Taxes*

The Company uses the asset and liability method of accounting for income taxes. Accordingly, deferred tax liabilities and assets are determined based on the difference between the financial statement and tax bases of assets and liabilities, using enacted tax rates in effect for the year in which the differences are expected to reverse. Current income taxes are based on the year's taxable income for federal and state income tax reporting purposes.





**1. Business and Significant Accounting Policies (continued)**

*Income Taxes (continued)*

The Company's net deferred tax assets at December 31, 2015 consist principally of net operating losses and the Company provided a 100% valuation allowance for the tax effect of these net operating losses. No benefit for income taxes has been provided in the accompanying statement of operations since all deferred tax assets have been fully reserved. The Company provided the valuation allowance since management could not determine that it was "more likely than not" that the benefits of the deferred tax assets would be realized.

*Uncertain Tax Positions*

GAAP prescribes a comprehensive model for how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that it has taken or expects to take on a tax return. A favorable tax position may be included in the calculation of tax liabilities and expenses if a company concludes that it is more likely than not that its adopted tax position will prevail if challenged by tax authorities. The Company did not recognize any adjustments regarding its tax accounting treatments for the year ended December 31, 2015.

*Stock-based Compensation*

The Company's employee share-based awards result in a cost that is measured at fair value on the awards' grant date, based on the estimated number of awards that are expected to vest. Stock-based compensation is recognized on a straight-line basis over the award vesting period.

Transactions with non-employees in which goods or services are the consideration received for the issuance of equity instruments are accounted for based on the fair value of the consideration received or the fair value of the equity instrument issued, whichever is more reliably measurable. The measurement date of the fair value of the equity instrument issued is the earlier of the date on which the counterparty's performance is complete or the date on which it is probable that performance will occur.

*Comprehensive Income (Loss)*

Comprehensive income/loss is defined as the change in equity during a period from transactions and other events from non-owner sources. The components of comprehensive income/loss, including net loss, are reported in the financial statements in the period in which they are recognized. Net loss and other comprehensive loss shall be reported, net of their related tax effect to arrive at comprehensive loss. In particular, this included the effect of unrealized losses on short-term investments for the year ended December 31, 2015.





## 1. Business and Significant Accounting Policies (continued)

*Recent Accounting Pronouncements*

On May 28, 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") ASU 2014-09 regarding ASC Topic 606, *Revenue from Contracts with Customers*. The standard provides principles for recognizing revenue for the transfer of promised goods or services to customers with the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance, as amended in July 2015, will be effective for the Company's fiscal year beginning January 1, 2019. Early adoption is not permitted. Management is currently evaluating the accounting, transition and disclosure requirements of the standard to determine the financial statement impact of adoption.

In July 2015, FASB issued ASU 2015-11, Inventory regarding ASC Topic 330, *Simplifying the Measurement of Inventory*. Topic 330 currently requires an entity to measure inventory at the lower of cost or market, where market could be replacement cost, net realizable value, or net realizable value less an approximately normal profit margin. This ASU limits the scope to inventory that is measured using first-in, first-out (FIFO) or average cost and requires inventory be measured at the lower of cost or net realizable value. The new standard is effective for fiscal years beginning after December 15, 2016. The Company will evaluate the impact of this adoption in 2017.

In February 2016, the FASB issued ASU 2016-02, *Leases*, which requires lessees to recognize "right of use" assets and liabilities for all leases with terms of more than 12 months. The ASU requires additional quantitative and qualitative financial statement note disclosures about the leases, significant judgments made in accounting for those leases and amounts recognized in the financial statements about those leases. The guidance will be effective for the Company in 2020 with early adoption permitted. Management is evaluating the impact that adopting this guidance will have on the financial statements.





## 2. Inventories

Inventories, net consisted of the following at December 31:

| | | 2015 |
|---|---|---|
| Raw materials | $ | 409,117 |
| Work-in-progress | | 575,211 |
| Finished goods | | 390,236 |
| | | 1,374,564 |
| Provision for obsolete inventories | | (20,507) |
| | $ | 1,354,057 |

Inventory in-transit of $29,904 was included within raw materials as of December 31, 2015.

## 3. Property and Equipment

Property and equipment, net consisted of the following at December 31:

| | | 2015 |
|---|---|---|
| Furniture and fixtures | $ | 75,615 |
| Office equipment and trade booths | | 443,956 |
| Lab equipment | | 411,597 |
| Leasehold improvements | | 439,739 |
| Construction in progress | | 14,970 |
| | | 1,385,877 |
| Less accumulated depreciation | | (737,066) |
| Property and equipment, net | $ | 648,811 |

Depreciation expense for the year ended December 31, 2015 was $105,154, and is included within selling, general and administrative expenses on the accompanying statement of operations.





**4. Notes Payable to Bank**

February 2013 Debt Financing

In February 2013, the Company signed a loan and security agreement with a bank. Under the terms of the agreement, the Company may draw, in two tranches, up to an aggregate amount of $5,000,000 for operating capital through March 31, 2014. The first tranche draw period is from the effective date of the loan and security agreement through June 30, 2013, and the amount of capital available in the first tranche draw period is $3,000,000. The second tranche draw period is from the date on which the bank receives satisfactory evidence that the Company has received six consecutive months of positive post-device removal data from the current IDE trial (the Tranche B Effective Date) through March 31, 2014, and the amount of capital available in the second tranche draw period is $2,000,000. In June 2013, the Company borrowed the first tranche loan amount of $3,000,000. In March 2014, the Company borrowed the second tranche loan amount of $2,000,000.

With respect to all first tranche capital draws, principal and interest payments are due as follows: monthly interest payments only through December 31, 2013, at an annual floating interest rate of 2.75% above the prime rate; and 33 equal consecutive monthly payments of principal and interest beginning January 1, 2014, at a fixed annual rate of 2.75% above the prime rate at January 1, 2014 (6% at January 1, 2014 and December 31, 2014).

With respect to all second tranche capital draws, principal and interest payments are due as follows: monthly interest payments only through September 30, 2014, at an annual floating interest rate of 2.75% above the prime rate; and 27 equal consecutive monthly payments of principal and interest beginning October 1, 2014, at a fixed annual rate of 2.75% above the prime rate at October 1, 2014 (6% at October 1, 2014 and December 31, 2014).

In addition to principal and interest payments, a final payment equal to 3.5% of the capital draws is due upon termination of the loan. This final payment was made in March 2015 when the remaining principal balance was paid off. At December 31, 2015, the total amount of loan principal outstanding on the loan and security agreement was $0.

In connection with the above loan agreement, the Company issued warrants to purchase 243,902 shares (the "Initial Shares") of the Company's Series C Preferred Stock at a purchase price of $0.82 per share. The fair value of the Initial Shares was determined by using the Black-Scholes option-pricing model, with the following assumptions: (i) no expected dividends; (ii) a risk-free interest rate of 1.38%; (iii) expected volatility of 53.0%; and (iv) an expected life of the warrants of seven years. The fair value of the Initial Shares was capitalized as loan issue costs of $107,986 and is amortized to interest expense over the term of the loan using the effective interest method. The issued warrants expire on February 12, 2020, subject to automatic exercise upon expiration. At December





**4. Notes Payable to Bank (continued)**

31, 2015, there were 243,902 warrants fully-vested and outstanding, recorded as a liability with a fair value of $102,435.

February 2013 Debt Financing (continued)

In addition to the Initial Shares granted to the bank, on the Tranche B Effective Date, the Company issued to the bank warrants to purchase an additional 121,951 shares (the "Tranche B Shares") of the Company's Series C Preferred Stock at a purchase price of $0.82 per share. The fair value of the Tranche B Shares was determined by using the Black-Scholes option-pricing model, with the following assumptions: (i) no expected dividends; (ii) a risk-free interest rate of 1.38%; (iii) expected volatility of 55.0%; and (iv) an expected life of the warrants of 7.0 years. The fair value of the Tranche B Shares was recorded as a debt discount of $65,347 and is amortized to interest expense over the term of the loan using the effective interest method. The issued warrants expire on February 12, 2020, subject to automatic exercise upon expiration. At December 31, 2015, there were 121,951 warrants fully-vested and outstanding, recorded as a liability with a fair value of $56,317.

The unamortized balance of $35,650 related to the warrants for Tranches A and B was amortized to interest expense in March 2015 when the indebtedness under the notes was fully repaid.

March 2015 Debt Financing

In March 2015, the Company signed a loan and security agreement ("Loan Agreement") with two co-lenders. Under the terms of the Loan Agreement, the Company borrowed $7,000,000 on March 31, 2015 ("Term A Loan") and may draw an additional amount of up to $5,000,000 ("Term B Loan") during a second draw period ending April 30, 2015 as defined in the Loan Agreement. The proceeds from the Term A Loan were used to provide operating capital and to repay the full amount of outstanding indebtedness on the notes payable to the bank. The Term B Loan was not drawn on by the Company.

The Company shall make monthly payments of interest only commencing on the funding date and continuing up to the amortization date, which is November 1, 2016. Beginning on the amortization date, the Company shall make equal monthly payments of principal and interest over a period of thirty months. The principal amount outstanding shall accrue interest at a floating per annum rate equal to the greater of 8.15% or the sum of the three month LIBOR rate plus 7.89% (8.31% at December 31, 2015). All unpaid principal and accrued interest is due and payable on April 1, 2019.

In addition to principal and interest payments, a final payment equal to 5.25% percent of the Term A principal balance is due upon termination of the loan. The loan is collateralized by certain assets of the Company.





**4. Notes Payable to Bank (continued)**

March 2015 Debt Financing (continued)

In connection with the above Loan Agreement, the Company issued warrants to purchase 426,830 shares of the Company's Series C Preferred Stock at a purchase price of $0.82 per share. The fair value of the warrants was determined by using the Black-Scholes option-pricing model, with the following assumptions: (i) no expected dividends; (ii) a risk-free interest rate of 1.94%; (iii) expected volatility of 52.5%; and (iv) an expected life of the warrants of ten years. The fair value of the warrants was recorded as loan issue costs of $257,200 and is amortized to interest expense over the term of the loan using the effective interest method. The issued warrants expire on March 31, 2025, subject to automatic exercise upon expiration if they meet certain contingencies. At December 31, 2015, there were 426,830 warrants fully-vested and outstanding, recorded as a liability with a fair value of $250,706.

The aggregate annual maturities of the note payable are as follows:

| Year Ending December 31, | | |
|---|---|---|
| 2016 | $ | 421,449 |
| 2017 | | 2,664,631 |
| 2018 | | 2,894,584 |
| 2019 | | 1,019,336 |
| | $ | 7,000,000 |

**5. Convertible Promissory Notes and Warrants**

*Convertible Promissory Notes and Warrants Issued in 2014 and 2015*

In June 2014, the Company entered into a Note and Warrant Purchase Agreement (the "Purchase Agreement") whereby convertible promissory notes (the "Notes" or "Note") and warrants (the "Warrants") were issued to certain stockholders in exchange for cash ("Initial Closing"). The Notes issued in the Initial Closing have an aggregate principal amount of $4,000,000. In December 2014, the Purchase Agreement was amended whereby additional Notes in the aggregate principal amount of $1,250,000 and Warrants were issued to certain stockholders in exchange for cash ("Second Closing"). In January 2015, the Purchase Agreement was amended whereby additional Notes in the aggregate principal amount of $1,500,000 and Warrants were issued to certain stockholders in exchange for cash ("Third Closing"). In March 2015, the Purchase Agreement was amended whereby additional Notes in the aggregate principal amount of $2,000,000 and Warrants were issued to certain stockholders in exchange for cash ("Fourth Closing").

**5. Convertible Promissory Notes and Warrants (continued)**

*Convertible Promissory Notes and Warrants Issued in 2014 and 2015 (continued)*

The Notes accrue interest at a rate of 8% per annum on the outstanding principal balance. The outstanding principal and any unpaid accrued interest thereon (the "Indebtedness") was due and payable on December 31, 2015 (as amended), unless earlier converted into capital stock of the Company. Upon the consummation of a change of control as defined in the Notes, if not previously converted, the Note holders shall be entitled to receive payment of three times the Indebtedness. The Notes are secured by certain assets of the Company. At December 31, 2015, the outstanding principal on the Notes was $0.

Prior to the maturity date, upon the consummation of a qualified financing, as defined, all Indebtedness under this Note shall automatically convert into shares of the class of equity securities as are issued in the qualified financing, at a conversion price generally equal to the per-share price at which the related securities are sold in the qualified financing. Notwithstanding the foregoing, if the majority of note holders agree to convert all outstanding principal and unpaid accrued interest on the Notes, then all Notes shall convert into the same securities upon the same terms and conditions.

In connection with the Notes issued under the Purchase Agreement (as amended), the Company issued Warrants to the Note holders to purchase 1,219,510, 381,093, 457,314 and 609,754 shares of the Company's Series C Preferred Stock on the First, Second, Third and Fourth Closings, respectively. The Warrants have an exercise price of $0.82 per share. The Warrants were fully exercisable on the date of issuance and expire ten years from the issuance date.

The fair value of the Warrants as of the issuance date was $768,497, $240,153, $274,693 and $366,258 for the Warrants issued on the First, Second, Third and Fourth Closings, respectively. The fair value was determined using the Black-Scholes option-pricing model with the following assumptions:

| | |
|---|---|
| Expected volatility | 52.5%-55.0% |
| Dividend yield | 0% |
| Risk-free interest rates | 1.83% to 2.59% |
| Expected term | 10 Years |

The fair value of the Warrants is presented as a debt discount against the Notes and amortized to interest expense over the term of the related Notes using the effective interest method and as a liability on the accompanying balance sheet, which is revalued at each reporting period until the warrants are exercised or expire. As of December 31, 2015, the warrants are recorded as a liability with a fair value of $1,530,323.





**5. Convertible Promissory Notes and Warrants (continued)**

*Convertible Promissory Notes and Warrants Issued in 2014 and 2015 (continued)*

In August 2015, the Company entered into a stock purchase agreement whereby an aggregate amount of 8,309,122 shares of Series D Convertible Preferred Stock were issued in exchange for conversion of the Indebtedness to the Note holders totaling $9,341,945. The Company recognized interest expense of $1,082,429 for the unamortized portion of the warrants issued in connection with the First through Fourth Closings at the time of conversion.

**6. Stockholders' Equity**

*Preferred Stock*

The Company has authorized 71,152,828 shares of Preferred Stock with a par value of $.0001. The Preferred Stock is divided into series. The first series consists of 500,000 authorized shares and is designated Series S Convertible Preferred Stock. The second series consists of 4,687,500 authorized shares and is designated Series A Convertible Preferred Stock. The third series consists of 6,250,000 authorized shares and is designated Series B Convertible Preferred Stock. The fourth series consists of 25,916,528 authorized shares and is designated Series C Convertible Preferred Stock. The fifth series consists of 33,798,800 authorized shares and is designated Series D Convertible Preferred Stock

*Series D Convertible Preferred Stock*

In August 2015, the Company entered into a stock purchase agreement whereby an aggregate amount of 25,489,678 shares of Series D Convertible Preferred Stock were issued in exchange for $28,658,047 in cash (gross). Additionally, 8,309,122 shares of Series D Convertible Preferred Stock were issued in August 2015 in exchange for conversion of Indebtedness to stockholders totaling $9,341,945 (Note 5).

The Series D Convertible Preferred Stock contains a liquidation preference described below. Shares of Series D Convertible Preferred Stock are convertible at the holder's option into shares of common stock, initially on a share-for-share basis using a conversion rate of $1.12 per share. The conversion ratio may be adjusted upon certain events and for certain dilutive issuances, splits and combinations. Conversion is automatic in the event of a public offering of the Company's common stock meeting certain specified criteria or upon the election of 67% of the holders of the

Series D Preferred Stock, Series C Preferred Stock, Series B Preferred Stock, Series A Preferred Stock and Series S Preferred Stock, voting together as a single class.





**6. Stockholders' Equity (continued)**

*Series D Convertible Preferred Stock (continued)*

Dividends, if declared or upon the liquidation or winding up of the Company, are non-cumulative and are payable at the rate of 8% of the Series D Preferred Stock's original issue price per annum on each share. No dividends have been declared through December 31, 2015. Each share of Series D Preferred Stock has voting rights equal to the number of shares of common stock into which it is then convertible. Shares of the Series D Preferred Stock are not redeemable.

In the event that the Company has an unrestricted cash position of less than $5,000,000 or the Board of Directors determine the Company must raise additional equity capital, other than an initial public offering, then each Investor holding shares of Series D Preferred Stock shall have the right to purchase a pro rata share of additional Series D Preferred Stock at the purchase price of $1.1243 per share (as adjusted for any stock dividends, contributions, splits, recapitalizations and the like with respect to such shares). The amount of capital to be raised under these circumstances shall be the greater of $15,000,000 in net cash proceeds or an amount determined by the Board of Directors.

*Series C Convertible Preferred Stock*

In October 2012, the Company entered into a stock purchase agreement whereby an aggregate amount of 9,859,756 shares of Series C Convertible Preferred Stock were issued in two closings (October 2012 and December 2012) in exchange for $8,085,001 in cash. Additionally, 3,747,141 shares of Series C Convertible Preferred Stock were issued in October 2012 in exchange for conversion of indebtedness to stockholders totaling $3,072,656. As a result of the indebtedness' beneficial conversion feature, the Company recognized additional interest expense of $341,406 in 2012 and issued 416,349 shares of Series C Preferred Stock. Related issuance costs aggregated $91,422.

In March 2013, the Company completed the final closing of the Series C Preferred Stock purchase agreement whereby an aggregate amount of 8,432,928 shares of Series C Convertible Preferred Stock was issued in exchange for $6,915,001 in cash. Related issuance costs aggregated $17,842.





**6. Stockholders' Equity (continued)**

*Series C Convertible Preferred Stock (continued)*

The Series C Convertible Preferred Stock contains a liquidation preference described below. Shares of Series C Convertible Preferred Stock are convertible at the holder's option into shares of common stock, initially on a share-for-share basis using a conversion rate of $0.82 per share. The conversion ratio may be adjusted upon certain events and for certain dilutive issuances, splits and combinations. Conversion is automatic in the event of a public offering of the Company's common stock meeting certain specified criteria or upon the election of 67% of the holders of the Series D Preferred Stock, Series C Preferred Stock, Series B Preferred Stock, Series A Preferred Stock and Series S Preferred Stock, voting together as a single class.

Dividends, if declared or upon the liquidation or winding up of the Company, are non-cumulative and are payable at the rate of 8% of the Series C Preferred Stock's original issue price per annum on each share. No dividends have been declared through December 31, 2015. Each share of Series C Preferred Stock has voting rights equal to the number of shares of common stock into which it is then convertible. Shares of the Series C Preferred Stock are not redeemable.

*Series B Convertible Preferred Stock*

In October 2008, the Company entered into a stock purchase agreement whereby an aggregate amount of 6,250,000 shares of Series B Convertible Preferred Stock were issued in exchange for $20,000,000 in cash. Related issuance costs aggregated $120,767.

The Series B Convertible Preferred Stock contains a liquidation preference described below. Shares of Series B Convertible Preferred Stock are convertible at the holder's option into shares of common stock, initially on a share-for-share basis using a conversion rate of $3.20 per share. The conversion ratio may be adjusted upon certain events and for certain dilutive issuances, splits and combinations. Conversion is automatic in the event of a public offering of the Company's common stock meeting certain specified criteria or upon the election of 67% of the holders of the Series D Preferred Stock, Series C Preferred Stock, Series B Preferred Stock, Series A Preferred Stock and Series S Preferred Stock, voting together as a single class.

**6. Stockholders' Equity (continued)**

*Series B Convertible Preferred Stock (continued)*

Dividends, if declared or upon the liquidation or winding up of the Company, are non-cumulative and are payable at the rate of 8% of the Series B Preferred Stock's original issue price per annum on each share. No dividends have been declared through December 31, 2015. Each share of Series B Preferred Stock has voting rights equal to the number of shares of common stock into which it is then convertible. Shares of the Series B Preferred Stock are not redeemable.

*Series A Convertible Preferred Stock*

In May 2006, the Company entered into a stock purchase agreement whereby an aggregate amount of 2,812,500 shares of Series A Convertible Preferred Stock were issued in exchange for $4,500,000 in cash. Related issuance costs aggregated $73,932.

In August 2007, the Company entered into a stock purchase agreement whereby an aggregate amount of 1,875,000 shares of Series A Convertible Preferred Stock were issued in exchange for $3,000,000 in cash. Related issuance costs aggregated $22,408.

The Series A Convertible Preferred Stock contains a liquidation preference described below. Shares of Series A Convertible Preferred Stock are convertible at the holder's option into shares of common stock, initially on a share-for-share basis using a conversion rate of $1.60 per share. The conversion ratio may be adjusted upon certain events and for certain dilutive issuances, splits and combinations. Conversion is automatic in the event of a public offering of the Company's common stock meeting certain specified criteria or upon the election of 67% of the holders of the Series D Preferred Stock, Series C Preferred Stock, Series B Preferred Stock, Series A Preferred Stock and Series S Preferred Stock, voting together as a single class.

Dividends, if declared or upon the liquidation or winding up of the Company, are non-cumulative and are payable at the rate of 8% of the Series A Preferred Stock's original issue price per annum on each share. No dividends have been declared through December 31, 2015. Each share of Series A Preferred Stock has voting rights equal to the number of shares of common stock into which it is then convertible. Shares of the Series A Preferred Stock are not redeemable.





**6. Stockholders' Equity (continued)**

*Series S Convertible Preferred Stock*

In September 2005, the Company entered into a stock purchase agreement whereby an aggregate amount of 500,000 shares of Series S Preferred Stock were issued in exchange for $500,000 in cash. Related issuance costs aggregated $39,998.

The Series S Convertible Preferred Stock contains a liquidation preference described below. Shares of Series S Convertible Preferred Stock are convertible at the holder's option into shares of common stock, initially on a share-for-share basis using a conversion rate of $1.00 per share. The conversion ratio may be adjusted upon certain events and for certain dilutive issuances, splits and combinations. Conversion is automatic in the event of a public offering of the Company's common stock meeting certain specified criteria or upon the election of 67% of the holders of the Series C Preferred Stock, Series B Preferred Stock, Series A Preferred Stock and Series S Preferred Stock, voting together as a single class.

Dividends, if declared or upon the liquidation or winding up of the Company, are non-cumulative and are payable at the rate of 8% of the Series S Preferred Stock's original issue price per annum on each share. No dividends have been declared through December 31, 2015. Each share of Series S Preferred Stock has voting rights equal to the number of shares of common stock into which it is then convertible. Shares of the Series S Preferred Stock are not redeemable.

*Liquidation Preferences*

Upon liquidation, dissolution or winding up of the Company, the holders of the Series S Preferred Stock, Series A Preferred Stock, Series B Preferred Stock, Series C Preferred Stock and Series D Preferred Stock, on a pro rata basis, are entitled to receive, prior and in preference to any distribution from the assets of the Company to the holders of common stock, an amount per share equal to the original issue price of the Series S Preferred Stock, Series A Preferred Stock, Series B Preferred Stock, Series C Preferred Stock and Series D Preferred Stock, plus all declared but unpaid dividends.

After payment of the above amounts, the remaining assets of the Company available for distribution to the stockholders shall be distributed to the holders of the common stock.

See accompanying independent auditors' report.





**6. Stockholders' Equity (continued)**

*Common Stock*

The Company has authorized 100,000,000 shares of common stock with a par value of $.0001. In August 2005, the Company issued 1,625,000 shares of its common stock to founders in exchange for cash totaling $1,625.

In 2008, the Company issued 375,000 shares of the Company's common stock to consultants, subject to the terms of the 2005 Stock Incentive Plan and Restricted Stock Award Agreements as consideration for services provided. The aggregate value of the shares at issuance was as follows:

| | Number of Shares | Value per Share | Aggregate Value of Shares |
|---|---|---|---|
| January 2008 | 250,000 | $ 0.25 | $ 62,500 |
| July 2008 | 87,500 | $ 0.25 | $ 21,875 |
| November 2008 | 37,500 | $ 0.48 | $ 18,000 |

The shares were fully-vested upon issuance. The Company has a right of first refusal to purchase all or any shares offered for sale at the price specified in the offer. The rights provided the Company shall terminate upon the consummation of a public offering or immediately prior to the consummation of a change in control whereupon the shares will be exchanged for shares of a successor corporation, which corporation is publicly held.

In 2008, the Company issued 400,000 shares of the Company's common stock to a key employee, subject to the terms of the 2005 Stock Incentive Plan and a Restricted Stock Purchase Agreement in exchange for cash of $100,000. The restricted stock is subject to a right of first refusal as defined in the Restricted Stock Purchase Agreement. During the year ended December 31, 2015, 12,000 shares of common stock were issued in exchange for cash of $3,000, upon the exercise of options.

*Warrants*

In March 2008, the Company entered into a loan and security agreement with a bank. In connection with this loan agreement, the Company issued warrants to the bank to purchase 50,000 shares of the Company's Series A Preferred Stock at a per share price of $1.60. The warrants expired on March 14, 2015.

See accompanying independent auditors' report.





**6. Stockholders' Equity (continued)**

*Warrants (continued)*

In November 2011, the Company issued warrants to an outside consultant to purchase 26,533 shares of the Company's common stock at a per share price of $0.44 in exchange for services. The warrants expire on November 22, 2021. At December 31, 2015, there were 26,533 warrants fully-vested and outstanding.

In February 2013, the Company entered into a loan and security agreement with a bank (Note 4). In connection with this loan agreement, the Company issued warrants to the bank to purchase 365,853 shares of the Company's Series C Preferred Stock at a per share price of $0.82. The warrants expire on February 12, 2020. At December 31, 2015, there were 365,853 warrants fully-vested and outstanding.

In August 2013, the Company issued warrants to an outside consultant to purchase 36,836 shares of the Company's common stock at a per share price of $0.18 in exchange for services. The warrants expire on August 22, 2023. At December 31, 2015, there were 36,836 warrants fully-vested and outstanding.

In June 2014, the Company entered into note and warrant purchase agreements with stockholders (Note 5). In connection with the note agreements, the Company issued warrants to stockholders to purchase 2,667,671 shares of the Company's Series C Preferred Stock at a per share price of $0.82. 1,219,510 warrants expire on June 24, 2024, 381,093 warrants expire on December 1, 2024, 457,314 warrants expire January 27, 2025 and 609,754 warrants expire March 6, 2025. At December 31, 2015, there were 2,667,671 warrants fully-vested and outstanding.

In March 2015, the Company entered into a note and warrant purchase agreement with two banks (Note 4). In connection with the note agreement, the Company issued warrants to stockholders to purchase 426,830 shares of the Company's Series C Preferred Stock at a per share price of $0.82. The warrants expire on March 31, 2025. At December 31, 2015, there were 426,830 warrants fully-vested and outstanding.





## 7. Stock Options

The Company adopted the 2015 Stock Incentive Plan (the "2015 Plan") on October 26, 2015, which provides for the issuance of shares of the Company's common stock to employees, directors and consultants. The exercise price of options granted under the 2015 Plan is established by the Company's Board of Directors and no option shall have a term in excess of ten years from the option grant date. Options vest in various installments as outlined in the related stock option agreements, or as determined by the Company's Board of Directors. The 2015 Plan supersedes the previous 2005 Stock Incentive Plan under which options were issued through October 25, 2015.

The Company has reserved up to 8,300,000 shares of its common stock to provide for the issuance of shares of the Company's common stock to employees, directors and consultants under its stock option plan.

Total stock-based employee compensation expense for the year ended December 31, 2015 was $143,536. Stock-based employee compensation expense was determined using the fair value of stock options as of the grant date.

In 2015, the Company granted 75,583 options to non-employees in exchange for services. During the year ended December 31, 2015, the Company recorded stock-based compensation expense to non-employees of $25,656 in connection with non-employee options earned.

The fair value of each option grant in 2015 was estimated using the Black-Scholes option pricing model with the following assumptions:

| | |
|---|---|
| Expected volatility | 50.20% |
| Dividend yield | 0% |
| Risk free interest rates | 1.5% to 2.3% |
| Expected term - employees | 5.5 Years |
| Expected term - non-employees | 10 Years |

Expected volatility — Since the Company does not have sufficient stock price history to estimate the expected volatility of its shares, the expected volatility is calculated based on the average volatility for a public company peer group in the industry in which the Company does business.

Dividend yield of zero — The Company has not paid, and does not intend to pay, dividends.





## 7. Stock Options (continued)

Risk-free interest rates — The Company applies the risk-free interest rate based on the U.S. Treasury yield for the expected term of the option.

Expected term — For employees, the Company calculated the expected term as the average of the contractual term of the option and the vesting period for its employee stock options. For non-employees, the Company estimated the expected term as the contractual term of the award.

*Stock Option Activity*

A summary of stock option activity in 2015 is as follows:

| | Options Outstanding | Weighted Average Exercise Price |
|---|---|---|
| Balance, December 31, 2014 | 7,767,185 | $ 0.233 |
| Granted | 3,673,504 | 0.337 |
| Cancelled / Expired | (91,600) | 0.248 |
| Exercised | (12,000) | 0.250 |

| | | | |
|---|---|---|---|
| Balance, December 31, 2015 | 11,337,089 | $ | 0.267 |

The following table summarizes information concerning outstanding and exercisable stock options at December 31, 2015:

| | Options | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (Years) |
|---|---|---|---|
| Outstanding | 11,337,089 | $ 0.27 | 7.4 |
| Exercisable | 6,492,417 | $ 0.24 | 6.2 |

See accompanying independent auditors' report.





**7. Stock Options (continued)**

*Stock Option Activity (continued)*

As of December 31, 2015, total compensation cost related to nonvested options not yet recognized is $599,369, and the weighted average period over which this amount is expected to be recognized is 3.3 years. The weighted average grant date fair value of all stock options granted during the year ended December 31, 2015 is $0.16 per share.

**8. Commitments and Contingencies**

*Operating Leases*

In June 2008, the Company entered into an operating lease for office space in California which has been extended several times, most recently by Amendment No. 5 to the lease dated October 12, 2015. The lease amendment extended the terms of the lease through October 31, 2017.

In September 2015, the Company entered into an operating sublease for office space in California which expires on March 10, 2017. In October 2015, the Company entered into a separate lease for office and manufacturing space for a different portion of the same facility in California which expires on March 31, 2021.

Future minimum lease payments required under these leases are as follows for the years ending December 31:

| | | |
|---|---|---|
| 2016 | $ | 615,711 |
| 2017 | | 712,637 |
| 2018 | | 639,153 |
| 2019 | | 658,095 |
| 2020 | | 676,629 |
| 2021 | | 170,316 |
| | $ | 3,472,541 |

Rent expense for the year ended December 31, 2015 was $204,761.

See accompanying independent auditors' report.





**9. Related Party Transactions**

*Royalty Fees*

The Company is a party to a royalty agreement, and related amendments (together, the "Royalty Agreement"), with a company that is a stockholder that provides the Company the rights to use certain patents. In exchange, the Company is obligated to pay a royalty fee of 2.5% of net sales of products, as defined in the Royalty Agreement. Payments are due upon the U.S. or foreign patent applications listed in the Royalty Agreement being issued by the respective patent office. As of December 31, 2015, no patents have been issued. As of December 31, 2015, the Company has accrued $20,004 in royalty fees.

*Indemnities*

During the normal course of business, the Company has made certain indemnities under which it may be required to make payments in relation to certain transactions. These indemnities include (i) certain real estate leases, under which the Company may be required to indemnify property owners for general liabilities; and (ii) certain agreements with the Company's officers and directors, under which the Company may be required to indemnify such persons for liabilities arising out of their employment relationship and (iii) certain agreements with customers, under which the Company may be required to indemnify the customer for product related liabilities. The duration of these indemnities do not provide for any limitation of the maximum potential future payments that Company could be obligated to make. Historically, the Company has not been obligated to make significant payments for these obligations and no liabilities have been recorded for these indemnities in the accompanying balance sheet.

**10. Income Taxes**

The tax effects of temporary differences that give rise to significant portions of the net deferred tax assets are as follows as of December 31, 2015:

| | | |
|---|---|---|
| Net operating loss carryforwards | $ | 25,043,000 |
| Research credits and other state credits | | 1,151,000 |
| Depreciation and amortization | | 2,537,000 |
| Stock-based compensation | | 161,000 |
| | | 28,892,000 |
| Valuation allowance | | (28,892,000) |
| | | |
| | $ | — |

See accompanying independent auditors' report.





**10. Income Taxes (continued)**

Management has established a valuation allowance for the Company's net deferred tax assets due to the uncertainty that the deferred tax assets will be realized by the Company's ability to generate sufficient future taxable income.

At December 31, 2015, the Company had approximately $63,300,000 and $60,346,000 of net operating loss carryforwards for federal and state purposes, respectively, available to offset future taxable income. Federal net operating losses can be carried back for two years, and remaining, unused carrybacks can be carried forward 20 years. Net operating losses begin to expire in 2026 and 2016 for federal and state tax purposes, respectively. Utilization of the Company's net operating losses in future periods may be limited by Section 382 of the Internal Revenue Code due to changes in the Company's ownership structure, the effects of which have not been determined. At December 31, 2015, the Company had federal and state research and development credit carryforwards of $745,000 and $613,000, respectively, which begin to expire in 2026 for federal purposes and carry over indefinitely for state purposes.

**11. Subsequent Events**

The Company has evaluated subsequent events through May 26, 2016, the date the financial statements were available to be issued.

See accompanying independent auditors' report.

*For the three and nine months ended September 30, 2017 and 2016*

**RESHAPE MEDICAL, INC.**

**FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2017 AND 2016**

**Table of Contents**



**RESHAPE MEDICAL, INC.**

**Condensed Balance Sheets**
**(Unaudited)**

| | September 30, 2017 | December 31, 2016 (Note 1) |
|---|---|---|
| **Assets** | | |
| **Current assets** | | |
| Cash and cash equivalents | $ 6,313,490 | $ 4,641,125 |
| Accounts receivable, net | 385,690 | 694,842 |
| Inventories, net | 1,095,975 | 1,293,708 |
| Prepaid expenses and other current assets | 189,461 | 359,309 |
| Total current assets | 7,984,616 | 6,988,984 |
| Property and equipment, net | 303,291 | 329,732 |
| Other assets | 77,058 | 109,430 |
| Total assets | $ 8,364,965 | $ 7,428,146 |
| **Liabilities and Stockholders' Deficit** | | |
| **Current liabilities** | | |
| Accounts payable | 440,231 | 364,136 |
| Current portion of notes payable - bank | 1,944,444 | 2,800,000 |
| Convertible notes payable | 11,000,000 | — |
| Payroll-related liabilities | 576,559 | 914,697 |
| Accrued and other liabilities | 971,979 | 1,421,710 |
| Total current liabilities | 14,933,213 | 5,500,543 |
| **Long-term liabilities** | | |
| Notes payable - bank, less current portion and unamortized debt discount of $1,013,613 and $461,842, respectively | 7,541,944 | 3,638,991 |
| Warrant liabilities | 2,066,687 | 1,916,272 |
| Total liabilities | 24,541,844 | 11,055,806 |

See accompanying notes to condensed financial statements.



**RESHAPE MEDICAL, INC.**

**Condensed Balance Sheets (continued)**
**(Unaudited)**

| | September 30, 2017 | December 31, 2016 (Note 1) |
|---|---|---|
| **Commitments and contingencies (Note 7)** | | |
| **Stockholders' deficit** | | |
| Series D Convertible Preferred Stock, $0.0001 par value; 33,798,800 shares authorized, issued and outstanding at September 30, 2017 and December 31, 2016; liquidation preference of $37,999,992 at September 30, 2017 and December 31, 2016 | 3,380 | 3,380 |
| Series C Convertible Preferred Stock, $0.0001 par value; 25,916,528 shares authorized at September 30, 2017 and December 31, 2016; 22,456,174 shares issued and outstanding at September 30, 2017 and December 31, 2016; liquidation preference of $18,414,064 at September 30, 2017 and December 31, 2016 | 2,246 | 2,246 |
| Series B Convertible Preferred Stock, $0.0001 par value; 6,250,000 shares authorized, issued and outstanding at September 30, 2017 and December 31, 2016; liquidation preference of $20,000,000 at September 30, 2017 and December 31, 2016 | 625 | 625 |
| Series A Convertible Preferred Stock, $0.0001 par value; 4,687,500 shares authorized, issued and outstanding at September 30, 2017 and December 31, 2016; liquidation preference of $7,500,000 at September 30, 2017 and December 31, 2016 | 469 | 469 |
| Series S Convertible Preferred Stock, $0.0001 par value; 500,000 shares authorized, issued and outstanding at September 30, 2017 and December 31, 2016; liquidation preference of $500,000 at September 30, 2017 and December 31, 2016 | 50 | 50 |
| Common Stock, $0.0001 par value; 105,000,000 shares authorized at September 30, 2017 and December 31, 2016; 2,716,067 shares issued and outstanding at September 30, 2017 and December 31, 2016 | 272 | 264 |
| Additional paid-in capital | 85,847,604 | 85,457,727 |
| Accumulated deficit | (102,031,525) | (89,092,421) |
| Total stockholders' deficit | (16,176,879) | (3,627,660) |
| Total liabilities and stockholders' deficit | $ 8,364,965 | $ 7,428,146 |

See accompanying notes to condensed financial statements.



**RESHAPE MEDICAL, INC.**

**Condensed Statements of Operations and Comprehensive Loss**
**(Unaudited)**

| | Three Months Ended September 30, 2017 | Three Months Ended September 30, 2016 | Nine Months Ended September 30, 2017 | Nine Months Ended September 30, 2016 |
|---|---|---|---|---|
| **Revenue** | $ 803,649 | $ 1,423,745 | $ 2,587,754 | $ 4,675,075 |
| **Cost of goods sold** | 638,232 | 1,125,955 | 1,946,029 | 4,404,746 |
| Gross margin | 165,417 | 297,790 | 641,725 | 270,329 |
| **Operating expenses** | | | | |
| Selling, general and administrative | 3,297,468 | 3,523,182 | 10,231,970 | 10,172,112 |
| Regulatory and clinical | 315,433 | 627,132 | 1,006,025 | 1,698,480 |
| Research and development | 218,137 | 379,438 | 1,152,680 | 1,235,704 |
| Total operating expenses | 3,831,038 | 4,529,752 | 12,390,675 | 13,106,296 |
| Loss from operations | (3,665,620) | (4,231,962) | (11,748,950) | (12,835,967) |
| **Other income (expense) net** | | | | |
| Interest expense, net | (366,094) | (200,923) | (1,338,523) | (598,424) |
| Interest and investment income, net | 18,332 | 11,202 | 63,900 | 53,702 |
| Revaluation of warrant liabilities | 29,299 | 5,877 | 92,835 | 17,632 |
| Loss before income taxes | (3,984,084) | (4,415,806) | (12,930,738) | (13,363,057) |
| **Provision for income taxes** | 0 | (4,835) | (8,366) | (9,786) |
| Net loss and comprehensive loss | $ (3,984,084) | $ (4,420,641) | $ (12,939,104) | $ (13,372,843) |

See accompanying notes to condensed financial statements.

RESHAPE MEDICAL, INC.

Condensed Statements of Cash Flows
(Unaudited)

| | Nine Months Ended September 30, 2017 | Nine Months Ended September 30, 2016 |
|---|---|---|
| **Cash flows from operating activities** | | |
| Net loss | $ (12,939,104) | $ (13,372,843) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization expense | 171,912 | 183,528 |
| Stock-based compensation | 373,855 | 263,095 |
| Amortization of debt discount and issuance costs | 216,398 | 149,080 |
| Provision for obsolete inventories | 53,443 | 286,381 |
| Provision for product warranty | 120,332 | 259,000 |
| Provision for bad debts | 69,360 | 25,229 |
| Isuances and revaluation of warrant liabilities | 150,415 | (17,632) |
| Changes in operating assets and liabilities | | |
| Accounts receivable, net | 239,793 | (567,947) |
| Inventories, net | 144,290 | (304,472) |
| Prepaid expenses and other assets | 202,220 | (314,257) |
| Accounts payable | 76,095 | (177,853) |
| Payroll-related liabilities | (338,138) | 66,951 |
| Accrued and other liabilities | (570,064) | 80,968 |
| Net cash used in operating activities | (12,029,193) | (13,440,772) |
| **Cash flows from investing activities** | | |
| Purchases of short-term investments | (4,889,157) | (1,748,604) |
| Sales of short-term investments | 4,889,157 | 10,358,573 |
| Acquisition of property and equipment | (145,471) | (123,798) |
| Net cash (used in) provided by investing activities | (145,471) | 8,486,171 |
| **Cash flows from financing activities** | | |
| Principal payments on note payable to bank | (233,333) | — |
| Proceeds from modification of note payable to bank, net of debt issuance costs of $268,168 | 3,064,332 | — |
| Proceeds from convertible debt | 11,000,000 | — |
| Proceeds from the exercise of options | 16,030 | 24,322 |
| Net cash provided by financing activities | 13,847,029 | 24,322 |
| **Net increase (decrease) in cash and cash equivalents** | 1,672,365 | (4,930,279) |
| **Cash and cash equivalents, beginning of the year** | 4,641,125 | 10,375,143 |
| **Cash and cash equivalents, end of period** | $ 6,313,490 | $ 5,444,864 |

See accompanying notes to condensed financial statements.



RESHAPE MEDICAL, INC.

Notes to the Condensed Financial Statements
(Unaudited)

## 1. Business and Significant Accounting Policies

*Business*

ReShape Medical, Inc. (the "Company") was originally incorporated on August 22, 2005, under the name Abdominis, Inc., pursuant to the laws of the State of Delaware. In January 2007, the Company changed its name from Abdominis, Inc. to ReShape Medical, Inc. The Company has developed and currently markets and sells a U.S. Food and Drug Administration (FDA) approved unique non-surgical product for the treatment of obesity in the United States (U.S.).

On October 2, 2017 the Company was acquired by EnteroMedics Inc. (the acquirer), a publicly-traded corporation focused on the development of minimally invasive medical devices to treat obesity, metabolic diseases and other gastrointestinal disorders. Subsequent to the transaction, the Company began operating as a wholly-owned subsidiary of the acquirer.

*Basis of Presentation, Management's Plans and Liquidity*

The accompanying unaudited condensed financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") and include all adjustments necessary for the fair presentation of the Company's financial position, results of operations and cash flows.

The unaudited interim financial statements have been prepared on a basis consistent with the audited financial statements. Certain footnotes and other financial information that are normally required by GAAP have been condensed or omitted. In the opinion of management, the unaudited interim financial statements reflect all adjustments, which include normal recurring adjustments, necessary for the fair presentation of the Company's financial information, contained herein. The condensed balance sheet at December 31, 2016 has been derived from audited financial statements at that date, but excludes disclosures required by GAAP for complete financial statements. These interim financial statements do not include all disclosures required by GAAP and should be read in conjunction with the Company's financial statements and accompanying notes for the fiscal year ended December 31, 2016, which are included Exhibit 99.1 to this Form 8-K/A. The results for the period ended September 30, 2017 and 2016 are not necessarily indicative of the results to be expected for the year ending December 31, 2017 or for any other interim period.

There have been no significant changes in the Company's significant accounting policies during the nine months ended September 30, 2017, as compared with those disclosed in the Company's financial statements and accompanying notes for the fiscal year ended December 31, 2016, included in this Form 8-K/A.

See accompanying notes to condensed financial statements.





**1. Business and Significant Accounting Policies (continued)**

*Basis of Presentation, Management's Plans and Liquidity (continued)*

The Company has incurred operating losses and has experienced negative cash flows from operations since inception and has an accumulated deficit of $102,031,525 as of September 30, 2017. The Company used cash in its operations of $12,029,193 and $13,440,772 during the nine months ended September 30, 2017 and 2016, respectively. As of September 30, 2017 the Company has cash and equivalents of $6,313,490. In August of 2015, the Company received U.S. FDA approval of its product and began selling in the U.S. in October 2015. Successful development of the market for the Company's products and its ability to grow sales is dependent upon continued operations of the Company, which in turn is dependent upon the Company's continued ability to raise capital and to generate cash from future revenue and operations adequate to support the Company's cost structure.

Following the acquisition of the Company on October 2, 2017, as described above, the Company, as a wholly-owned subsidiary of the acquirer, is also now dependent upon the acquirer's ability to raise capital to support the Company's continued operations and cost structure.

In addition to consideration paid by the acquirer in the form of common stock and preferred stock of the acquirer, EnteroMedics paid approximately $5.0 million in cash consideration, which amount was immediately used to pay the Company's outstanding senior secured indebtedness and certain transaction expenses. See further information regarding acquisition in Note 9, Subsequent Events.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. The Company performed an analysis and concluded substantial doubt exists with respect to the Company being able to continue as a going concern through one year from the date of issuance of these financial statements. In order to meet its operating cash flow requirements, management's plans include raising capital through the issuance of equity and debt instruments. While the Company's management believes that it will continue to be successful in obtaining the necessary financing to fund its operations, there are no assurances that such additional funding will be achieved on acceptable terms, or at all. If the Company is not able to secure adequate additional funding, the Company may be forced to make reductions in spending, extend payment terms with suppliers, liquidate assets where possible, and or suspend or curtail planned programs. Any of these actions could materially harm the Company's business, result of operations, and future prospects, including its ability to continue as a going concern. The financial statements do not include





**1. Business and Significant Accounting Policies (continued)**

*Basis of Presentation, Management's Plans and Liquidity (continued)*

any adjustments relating to the recoverability and classification of recorded asset amounts or amounts and classification of liabilities that might be necessary should the Company be unable to continue in existence. If the Company is unable to obtain adequate capital, it could be forced to cease operations.

*Use of Estimates*

The preparation of financial statements in conformity with GAAP requires management to make informed estimates and assumptions that affect the reported amounts of assets and liabilities, and the disclosure of contingent assets and liabilities, at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Management considers many factors in selecting appropriate financial accounting policies

and controls and in developing estimates and assumptions that are used in the preparation of these financial statements. Management must apply significant judgment in this process.

In addition, other factors may affect estimates, including: expected business and operational changes, sensitivity and volatility associated with the assumptions used in developing estimates, and whether historical trends are expected to be representative of future trends. The estimation process often may yield a range of potentially reasonable estimates of the ultimate future outcomes and management must select an amount that falls within that range of reasonable estimates. The most significant estimates in the accompanying financial statements relate to the valuation of the Company's common stock, warrants, other equity awards, provision for product warranty, and obsolete and slow-moving inventory. This process may result in actual results differing materially from those estimated amounts used in the preparation of the financial statements under different assumptions or conditions.

*Cash and Cash Equivalents*

The Company considers all highly liquid investments with a maturity of three months or less, when acquired, to be cash equivalents. Substantially all of the Company's cash and cash equivalents are maintained at one financial institution domiciled in the United States. Amounts on deposit with this financial institution may, from time to time, exceed the federally-insured limit, as well as coverage provided by the Securities Investment Protection Corporation. As of September 30, 2017 there were no cash equivalents held by the company and all of the Company's cash is held in readily available checking accounts. As of December 31, 2016 all of the Company's cash and cash equivalents are held in readily available checking and money market accounts.



---



**1. Business and Significant Accounting Policies (continued)**

*Short-term Investments*

Short-term investments are comprised of commercial paper and corporate obligations with original maturity dates greater than ninety days and less than one year. The Company classifies its short-term investments as available for sale securities with net unrealized gains or losses recorded as a component of stockholders' deficit. Realized gains and losses are included as other income (expense) in the statement of operations and comprehensive loss. The cost basis for realized gains and losses on available-for-sale securities is determined on a specific identification basis. Management determines the appropriate classification of its investments at the time of purchase and reevaluates such determination at each balance sheet date. The Company periodically reviews its investments for other than temporary declines in fair value below the cost basis and whenever events or changes

in circumstances indicate that the carrying value of an asset may not be recoverable. As of September 30, 2017 and December 31, 2016 there were no short-term investments held by the Company.

*Accounts Receivable*

Trade accounts receivable are stated at the amount the Company expects to collect. The Company maintains allowances for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. Management considers the following factors when determining the collectability of specific customer accounts: customer credit worthiness, past transaction history with the customer, current economic industry trends, and changes in customer payment terms. If the financial condition of the Company's customers were to deteriorate, adversely affecting their ability to make payments, additional allowances would be required. Based on management's assessment, the Company provides for estimated uncollectible amounts through a charge to earnings

and a credit to a valuation allowance. Balances that remain outstanding after the Company has used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to accounts receivable. The Company recorded a valuation allowance of $107,715 and $38,355 as of September 30, 2017 and December 31, 2016, respectively.

*Inventories*

Inventories are valued at the lower of cost, determined on a first-in, first-out ("FIFO") basis, or market. Management evaluates inventory for excess quantities and obsolescence and records an allowance to reduce the carrying value of inventory as determined necessary.



---

**1. Business and Significant Accounting Policies (continued)**

*Property and Equipment*

Property and equipment are recorded at cost. The Company provides for depreciation over estimated useful lives of two to three years, or the life of the related lease for leasehold improvements, if shorter, using the straight-line method. Repairs and maintenance expenditures that do not significantly add value to property and equipment, or prolong its life, are charged to operations as incurred. Gains and losses on dispositions of property and equipment are included in the operating results of the related period.

*Impairment of Long-lived assets*

The Company will record impairment losses on long-lived assets used in operations when events and circumstances indicate that assets might be impaired and the undiscounted cash flows estimated to be generated by those assets are less than the carrying amount of those

assets. An impairment analysis is subjective and assumptions regarding future growth rates and operating expense levels can have a significant impact on the expected future cash flows and impairment analysis. In December 2016, the Company recognized an impairment of $208,383 for leasehold improvements due to its plan to move to a new facility.

While the Company's current and historical operating losses and cash flows are indicators of impairment, the Company believes that future cash flows from operating activities and financing activities will exceed the carrying value of its long-lived assets and accordingly, exclusive of the above, the Company has not recognized any other impairment losses through September 30, 2017.

*Concentrations*

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash, short-term investments and accounts receivable. The Company maintains balances that at times may exceed amounts that are federally-insured or insured by the Securities Investor Protection Corporation. Management mitigates such potential risks by maintaining the Company's cash and short-term investment balances with entities that management believes possess high-credit quality and does not anticipate any losses with regards to these amounts.

The Company believes the concentration of credit risk in its accounts receivable is mitigated by its credit evaluation process, relatively short collection terms and the level of credit worthiness of its customers.





**1. Business and Significant Accounting Policies (continued)**

*Fair Value Measurements*

The Company measures fair value based on a three-level hierarchy of inputs, of which the first two are considered observable and the last unobservable. Unobservable inputs reflect the Company's own assumptions about current market conditions. The three-level hierarchy of inputs is as follows:

- Level 1 — Observable inputs such as unadjusted 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 - Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported by little or no market activity).

The fair value of the Company's financial assets and liabilities measured on a recurring basis is as follows:

| | Balance as of September 30, 2017 | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs |
|---|---|---|---|---|
| Liabilites | | | | |
| Warrant liabilities | $ 2,066,687 | $ — | $ — | $ 2,066,687 |
| | $ 2,066,687 | $ — | $ — | $ 2,066,687 |

| | Balance as of December 31, 2016 | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs |
|---|---|---|---|---|
| Assets | | | | |
| Cash equivalents | $ 2,566,512 | $ 2,566,512 | $ — | $ — |
| | $ 2,566,512 | $ 2,566,512 | $ — | $ — |

| | Balance as of December 31, 2016 | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs |
|---|---|---|---|---|
| Liabilites | | | | |
| Warrant liabilities | $ 1,916,272 | $ — | $ — | $ 1,916,272 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| | $ | 1,916,272 | $ | — | $ | — | $ | 1,916,272 |





**1. Business and Significant Accounting Policies (continued)**

*Fair Value Measurements (continued)*

The fair value of the Company's cash equivalents were determined using Level 1 inputs. Unadjusted quoted prices for these securities are regularly provided to the Company by independent pricing services.

The fair value of the Company's Series C Preferred Stock warrants were determined by the use of the Black-Scholes option-pricing model under the following assumptions:

| | September 30, 2017 | December 31, 2016 |
|---|---|---|
| Expected volatility | 48.0% | 48.0%-50.0% |
| Dividend yield | 0% | 0% |
| Risk-free interest rate | 1.49%-2.17% | 2.25%-2.35% |
| Expected term | 2-7 years | 3-8 years |
| Fair value of Series C Preferred Stock | $0.98 | $0.98 |

The fair value of the Company's Series D Preferred Stock warrants were determined by the use of the Black-Scholes option-pricing model under the following assumptions:

| | September 30, 2017 |
|---|---|
| Expected volatility | 48.00% |
| Dividend yield | 0% |
| Risk-free interest rate | 2.34% |
| Expected term | 9.25 years |
| Fair value of Series D Preferred Stock | $1.12 |

Given the absence of a public trading market, the Company determined the fair value of the Series C and Series D Preferred Stock through the use of objective and subjective factors. These factors included, but were not limited to (i) valuations performed by unrelated third-party specialists which included fair value estimates about the Company's securities and (ii) the prices for Series C and Series D Preferred Stock sold in the Company's preferred stock purchase agreements.





**1. Business and Significant Accounting Policies (continued)**

*Stock warrants*

The Company has issued freestanding warrants to purchase shares of its convertible preferred stock which are accounted for as a liability due to the nature of the underlying redemption provisions of the preferred stock into which the warrants are exercisable. The warrants are recorded on the Company's balance sheets at their fair value as determined on the date of issuance and are revalued at each subsequent balance sheet date, with fair value changes recognized as other income or expense in the accompanying statements of operations and comprehensive loss. The Company will continue to adjust the liability for changes in fair value until the earlier of the exercise or expiration of the warrants, the completion of a deemed liquidation event, the conversion of convertible preferred stock into common stock, or until the holders of the convertible preferred stock can no longer trigger a deemed liquidation event. Pursuant to the terms of these warrants, upon the conversion of the class of preferred stock underlying the warrant, the warrants automatically become exercisable for shares of the Company's common stock based upon the conversion ratio of the underlying class of preferred stock. The consummation of an initial public offering will result in the conversion of all classes of the Company's preferred stock into common stock. Upon such conversion of the underlying classes of preferred stock, the warrants will be classified as a component of equity and will no longer be subject to remeasurement. The Company estimates the fair value of the liability using option pricing models and assumptions that are based on the individual characteristics of the warrants or instruments on the valuation date, including assumptions for expected volatility, expected life, yield, and risk-free interest rate.

A summary of preferred stock warrant activity is as follows:

| | Three months ended September 30, 2017 | | | Three months ended September 30, 2016 | | |
|---|---|---|---|---|---|---|
| | Number of Shares | | Liability | Number of Shares | | Liability |
| Balance at June 30 | 3,816,130 | $ | 2,095,986 | 3,460,354 | $ | 1,928,027 |

| | | | | |
|---|---|---|---|---|
| Issuances | — | — | — | — |
| Exercises | — | — | — | — |
| Change in fair value | — | (29,299) | — | (5,877) |
| Balance at September 30 | 3,816,130 | $ 2,066,687 | 3,460,354 | $ 1,922,150 |





**1. Business and Significant Accounting Policies (continued)**

| | Nine months ended September 30, 2017 | | Nine months ended September 30, 2016 | |
|---|---|---|---|---|
| | Number of Shares | Liability | Number of Shares | Liability |
| Balance at December 31 | 3,460,354 | $ 1,916,272 | 3,460,354 | $ 1,939,781 |
| Issuances | 355,776 | 243,250 | — | — |
| Exercises | — | — | — | — |
| Change in fair value | — | (92,835) | — | (17,632) |
| Balance at September 30 | 3,816,130 | $ 2,066,687 | 3,460,354 | $ 1,922,149 |

There were no transfers between levels within the fair value hierarchy during the periods presented.

*Revenue Recognition*

Revenue is recognized when persuasive evidence of the arrangement exists, delivery and performance has occurred, the price is fixed and determinable and collectability is probable. Generally, these criteria are met at the time products are shipped. Provisions for discounts are recorded and are classified as reductions to revenues.

*Shipping and Handling*

The Company records amounts invoiced to its customers for outbound freight and shipping as revenue and the related expense as cost of goods sold.

*Warranty Accrual*

The Company's products are covered by a one year warranty policy against defective products at the time of shipment. In the event that a product is defective, the Company may replace the product or refund the purchase price or a portion thereof. The Company estimates future warranty costs by analyzing the timing, cost and amount of returned product and by considering future expectations.





**1. Business and Significant Accounting Policies (continued)**

*Warranty Accrual (continued)*

Assumptions and historical warranty experience are evaluated periodically to determine the continued appropriateness of such assumptions. The Company recorded a reserve for warranty claims in the amount of approximately $95,576 and $171,000 as of September 30, 2017 and December 31, 2016, respectively, which is included within accrued and other liabilities on the accompanying balance sheets.

*Foreign Currency*

The Company maintains a foreign bank account for purposes of collecting trade receivables from foreign customers. Foreign bank balances are translated at the rates of exchange at the balance sheet date. Gains and losses resulting from foreign currency transactions are recorded within other income in the accompanying statements of operations and comprehensive loss.

*Patent-related Expenditures*

Expenditures related to patent research and applications, which are primarily comprised of legal fees, are expensed as incurred.

*Research and Development*

Research and development costs are expensed when incurred.

*Income Taxes*

The Company uses the asset and liability method of accounting for income taxes. Accordingly, deferred tax liabilities and assets are determined based on the difference between the financial statement and tax bases of assets and liabilities, using enacted tax rates in effect for the year in which the differences are expected to reverse. Current income taxes are based on the year's taxable income for federal and state income tax reporting purposes. The likelihood of realizing the tax benefits related to a potential deferred tax benefit is evaluated, and a valuation allowance is recognized to reduce that deferred tax asset if it is more likely than not that all or some portion of the deferred tax asset will not be realized.

The Company's net deferred tax assets at September 30, 2017 and December 31, 2016 consist principally of net operating losses and the Company provided a 100% valuation allowance for the tax effect of these net operating losses. No benefit for income taxes has been provided in the accompanying statements of operations and comprehensive loss since





**1. Business and Significant Accounting Policies (continued)**

*Income Taxes (continued)*

all deferred tax assets have been fully reserved. The Company provided the valuation allowance since management could not determine that it was "more likely than not" that the benefits of the deferred tax assets would be realized.

The Company is required to file federal and state income tax returns in the United States and various other state jurisdictions. The preparation of these state tax returns requires the Company to interpret the applicable tax laws and regulations in effect in such jurisdictions, which could affect the amount of tax paid by the Company.

*Uncertain Tax Positions*

GAAP prescribes a comprehensive model for how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that it has taken or expects to take on a tax return. A favorable tax position may be included in the calculation of tax liabilities and expenses if a company concludes that it is more likely than not that its adopted tax position will prevail if challenged by tax authorities. Where applicable, associated interest and penalties are also recorded. The Company did not recognize any adjustments regarding its tax accounting treatments for the three and nine months ended September 30, 2017 and 2016, respectively. The Company is subject to continuous examination of its income tax returns by the U.S. Internal Revenue Service and other tax authorities since inception.

*Stock-based Compensation*

The Company accounts for stock options granted to employees, directors and consultants using a fair value method, which requires the recognition of compensation expense for costs related to all stock-based payments, including stock options. The Company's employee share-based awards result in a cost that is measured at fair value on the awards' grant date, using a Black-Scholes option-pricing model, based on the estimated number of awards that are expected to vest. Stock-based compensation is recognized on a straight-line basis over the award vesting period.

Transactions with non-employees in which goods or services are the consideration received for the issuance of equity instruments are accounted for based on the fair value of the consideration received or the fair value of the equity instrument issued, whichever is more reliably measurable.





**1. Business and Significant Accounting Policies (continued)**

*Stock-based Compensation (continued)*

The measurement date of the fair value of the equity instrument issued is the earlier of the date on which the counterparty's performance is complete or the date on which it is probable that performance will occur.

The Black-Scholes option-pricing model requires assumptions, such as the value of the Company's common stock, the risk-free interest rate, dividend yield, expected term and expected volatility. Further, the forfeiture rate also affects the amount of aggregate compensation. The following assumptions are subjective and generally require significant management judgment:

*Common stock value* — the fair value of the shares of common stock underlying stock options is determined by the Company's Board of Directors (the "Board") for the stock option plan. Since there is no public market for the common stock, the Board determines the common stock fair value at the time of each option grant by considering a number of objective and subjective factors. These include the valuation of several public peer group companies within the medical device industry that focus on technological advances and development that the Board believes is comparable to the Company's operations. Factors such as operating and financial performance, the lack of liquidity of the common stock and trends in the broader economy and medical device industry also have an impact on the determination of the fair value of the common stock. In addition, the Company regularly engages a third party valuation specialist to assist with estimates related to the valuation of the common stock.

*Expected volatility* — Since the Company does not have sufficient stock price history to estimate the expected volatility of its shares, the expected volatility is calculated based on the average volatility for a public company peer group in the industry in which the Company does business.

*Dividend yield of zero* — The Company has not paid, and does not intend to pay, dividends.

*Risk-free interest rates* — The Company applies the risk-free interest rate based on the U.S. Treasury yield for the expected term of the option.





**1. Business and Significant Accounting Policies (continued)**

*Stock-based Compensation (continued)*

*Expected term* — For employees, the Company calculated the expected term using the "simplified method", which represents the average of the contractual term of the option and the vesting period for its employee stock options. For non-employees, the Company estimated the expected term as the contractual term of the award.

*Forfeiture rate* — estimated at the time of the grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

*Comprehensive Income (Loss)*

Comprehensive income (loss) is defined as the change in equity during a period from transactions and other events from non-owner sources. The components of comprehensive income (loss), including net loss, are reported in the financial statements in the period in which they are recognized. Net loss and other comprehensive loss shall be reported net of their related tax effect to arrive at comprehensive loss. The Company did not have any unrealized income or losses on short-term investments to recognize for the three and nine months ended September 30, 2017 and 2016, respectively.

*Recent Accounting Pronouncements*

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") ASU 2014-09 regarding ASC Topic 606, *Revenue from Contracts with Customers*. The standard provides principles for recognizing revenue for the transfer of promised goods or services to customers with the consideration to which the entity expects to be entitled in exchange for those goods or services. This guidance becomes effective for the Company beginning fiscal year 2019 with early adoption permitted as of January 1, 2017. The Company was acquired on October 2, 2017 and its acquirer intends to use the modified retrospective approach when it adopts the standard as required January 1, 2018. The implications of the adoption of the new standard as it relates to sales of the Company's products are currently being evaluated. Additionally, the new standard will likely require incremental revenue disclosures that may be significant.

In August 2014, the FASB issued ASU No. 2014-15, *Disclosure of Uncertainties About an Entity's Ability to Continue as a Going Concern*. The standard requires management to perform interim and annual assessments of an entity's ability to continue as a going concern within one year of the date the financial statements are issued and provides guidance on determining when and how to disclose going concern uncertainties in the financial statements. Certain disclosures are required if conditions given rise to substantial doubt about an entity's ability to continue as a going concern. ASU 2014-15 was adopted by the





**1. Business and Significant Accounting Policies (continued)**

*Recent Accounting Pronouncements (continued)*

Company effective December 31, 2016 and these financial statements disclose management's conclusion with respect to substantial uncertainty about the Company's ability to continue as a going concern for twelve months from the date these financial statements are issued.

In July 2015, FASB issued ASU 2015-11, Inventory regarding ASC Topic 330, *Simplifying the Measurement of Inventory*. Topic 330 currently requires an entity to measure inventory at the lower of cost or market, where market could be replacement cost, net realizable value, or net realizable value less an approximately normal profit margin. This ASU limits the scope to inventory that is measured using FIFO or average cost and requires inventory be measured at the lower of cost or net realizable value. The new standard is effective for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. Management is currently evaluating the accounting, transition and disclosure requirements of the standard to determine the financial statement impact of adoption.

In February 2016, the FASB issued ASU 2016-02, *Leases*, which requires lessees to recognize "right of use" assets and liabilities for all leases with terms of more than 12 months. The ASU requires additional quantitative and qualitative financial statement note disclosures about the leases, significant judgments made in accounting for those leases and amounts recognized in the financial statements about those leases. The guidance will be effective for the Company in 2020 with early adoption permitted. Management is evaluating the impact that adopting this guidance will have on the financial statements.

In March 2016, the FASB issued ASU No. 2016-09, *Compensation - Stock Compensation (Topic 718)*. The new standard requires income tax effects of stock compensation awards to be recognized in the income statement when the awards vest or are settled. The new standard also allows the Company to repurchase more of an employee's shares for tax withholding purposes without triggering liability accounting and to make a policy election to account for forfeitures as they occur. The new standard is effective for annual periods beginning after December 15, 2017, and early adoption is permitted. The Company is currently evaluating the impact of ASU 2016-09 on its financial statements.

Management does not believe that any other recently issued, but not yet effective, accounting pronouncements, if adopted, would have a material effect on the accompanying financial statements.





## 2. Inventories

Inventories, net consisted of the following at:

| | September 30, 2017 | December 31, 2016 |
|---|---|---|
| Raw materials | $ 505,374 | $ 440,651 |
| Work-in-progress | 250,901 | 310,007 |
| Finished goods | 534,063 | 683,970 |
| | 1,290,338 | 1,434,628 |
| Provision for obsolete inventories | (194,363) | (140,920) |
| | $ 1,095,975 | $ 1,293,708 |

## 3. Property and Equipment

Property and equipment, net consisted of the following at:

| | September 30, 2017 | December 31, 2016 |
|---|---|---|
| Furniture and fixtures | $ 119,306 | $ 96,306 |
| Office equipment and trade booths | 467,237 | 467,237 |
| Lab equipment | 534,365 | 440,968 |
| Leasehold improvements | 200,682 | 466,338 |
| Construction in progress | 32,382 | 9,882 |
| | 1,353,972 | 1,480,731 |
| Less accumulated depreciation and amortization | (1,050,681) | (1,150,999) |
| Property and equipment, net | $ 303,291 | $ 329,732 |

Depreciation and amortization expense for the three and nine months ended September 30, 2017 was $56,365 and $171,912, respectively and for the three and nine months ended September 30, 2016 was $63,037 and $183,528, respectively.





## 4. Notes Payable and Warrants Issued to Bank

<u>February 2013 Debt Financing</u>

In February 2013, the Company signed a $5,000,000 loan and security agreement with a bank. In connection with the agreement, the Company issued warrants to purchase 243,902 shares (the "Initial Shares") of the Company's Series C Preferred Stock at a purchase price of $0.82 per share. The fair value of the Initial Shares was determined by using the Black-Scholes option-pricing model, with the following assumptions: (i) no expected dividends; (ii) a risk-free interest rate of 1.38%; (iii) expected volatility of 53.0%; and (iv) an expected life of the warrants of seven years. The fair value of the Initial Shares was capitalized as loan issue costs of $107,986 and is amortized to interest expense over the term of the loan on a straight-line method. The issued warrants expire on February 12, 2020, subject to automatic exercise upon expiration. At September 30, 2017 and

December 31, 2016 there were 243,902 warrants fully-vested and outstanding, recorded as a liability with a fair value of $87,148 and $96,311 as of September 30, 2017 and December 31, 2016, respectively.

In addition to the Initial Shares granted to the bank, on March 27, 2014, the Company issued to the bank warrants to purchase an additional 121,951 shares (the "Tranche B Shares") of the Company's Series C Preferred Stock at a purchase price of $0.82 per share. The fair value of the Tranche B Shares was determined by using the Black-Scholes option-pricing model, with the following assumptions: (i) no expected dividends; (ii) a risk-free interest rate of 1.38%; (iii) expected volatility of 55.0%; and (iv) an expected life of the warrants of 7.0 years. The fair value of the Tranche B Shares was recorded as a debt discount of $65,347 and is amortized to interest expense over the term of the loan using the straight-line method. The issued warrants expire on February 12, 2020, subject to automatic exercise upon expiration. At September 30, 2017 and December 31, 2016 there were 121,951 warrants fully-vested and outstanding, recorded as a liability with a fair value of $50,439 and $53,991 as of September 30, 2017 and December 31, 2016, respectively.

March 2015 Debt Financing

In March 2015, the Company signed a loan and security agreement ("Loan Agreement") with two co-lenders. Under the terms of the Loan Agreement, the Company borrowed $7,000,000 on March 31, 2015. Under the terms of the Loan Agreement, the Company shall make monthly payments of interest only commencing on the funding date and continuing up to the amortization date, which was November 1, 2016. Beginning on the amortization date, the Company shall make equal monthly payments of principal plus interest over a period of thirty months. The principal amount outstanding shall accrue interest at a floating per annum rate equal to the greater of 8.15% or the sum of the three month LIBOR rate plus 7.89% (8.56% at December 31, 2016). All unpaid principal and accrued interest is due and payable by April 1, 2019.





**4. Notes Payable and Warrants Issued to Bank (continued)**

March 2015 Debt Financing (continued)

In addition to the above principal and interest payments, a final payment equal to 5.25% percent of the initial principal balance is due upon termination of the loan ("Final Payment"). The Final Payment is $367,500 and was accrued at the commencement of the Loan Agreement with an offsetting accrual to unamortized debt discount. The Final Payment is being amortized to interest expense, on straight-line basis, over the term of the Loan Agreement. For the three and nine months ended September 30, 2016, the amount amortized and included in interest expense in the statement of operations and comprehensive loss is $22,968 and $68,906, respectively. At December 31, 2016, the Final Payment, net of unamortized debt discount of $206,723, is $160,777 and is recorded and included in Notes Payable. On February 1, 2017, in conjunction with the execution of The Amendment, as described below, the remaining unamortized debt discount balance of $199,067 was added to debt discount of the borrowings of the February 2017 Debt Financing and is being amortized to interest expense over the term of The Amendment. The loan is collateralized by certain assets of the Company.

In connection with the above Loan Agreement, the Company issued warrants to purchase 426,830 shares of the Company's Series C Preferred Stock at a purchase price of $0.82 per share. The fair value of the warrants was determined by using the Black-Scholes option-pricing model, with the following assumptions: (i) no expected dividends; (ii) a risk-free interest rate of 1.94%; (iii) expected volatility of 52.5%; and (iv) an expected life of the warrants of ten years. The fair value of the warrants was recorded as loan issue costs of $257,200 and is amortized to interest expense over the term of the loan. The issued warrants expire on March 31, 2025, subject to automatic exercise upon expiration if they meet certain contingencies. At September 30, 2017 and December 31, 2016, there were 426,830 warrants fully-vested and outstanding, recorded as a liability with a fair value of $238,970 and $249,183 as of September 30, 2017 and December 31, 2016, respectively.

On February 1, 2017, The Loan Agreement was modified as part of a new agreement, the February 2017 Debt Financing, as described below.

February 2017 Debt Financing

On February 1, 2017, the Company signed an Amendment ("The Amendment") to the March 2015 Loan Agreement. Under the terms of The Amendment, the Company borrowed $10,000,000 and shall make monthly payments of interest only commencing on the funding date and continuing up to the amortization date, which is March 1, 2018. Beginning on the amortization date, the Company shall make equal monthly payments of principal plus interest over a period of thirty-six months. The principal amount outstanding shall accrue interest at a floating per annum rate equal to the greater of 8.20% or the sum of the three month LIBOR rate plus 7.20% (8.52% at September 30, 2017). All unpaid principal and accrued interest is due and payable by February 1, 2021.





**4. Notes Payable and Warrants Issued to Bank (continued)**

February 2017 Debt Financing (continued)

In addition to the above principal and interest payments, a final payment equal to 5.0% percent of the $10,000,000 initial principal balance is due upon termination of The Amendment ("Amended Final Payment"). The Amended Final Payment is $500,000 and is being accrued and amortized to interest expense, over the term of The Amendment. During the three and nine months ended September 30, 2017, $31,250 and $83,333, respectively, was amortized and included in interest expense in the statement of operations and comprehensive loss. At September 30, 2017, the Amended Final Payment, net of unamortized debt discount of $416,667, is $83,333 and is recorded and included in Notes Payable. The loan is collateralized by certain assets of the Company.

The Company treated the execution of The Amendment as a modification for accounting purposes. The present value of the future cash flows under the terms of The Amendment did not exceed the present value of the future cash flows under the previous terms of the March 2015 Debt Financing by more than 10%. The final payment, the remaining balance of debt issuance costs and debt discount of the original, March 2015 Debt Financing loan are amortized to interest expense over the term of The Amendment using the effective interest method.

In connection with The Amendment, the Company issued warrants to purchase 355,776 shares of the Company's Series D Preferred Stock at a purchase price of $1.12 per share. The fair value of the warrants was determined by using the Black-Scholes option-pricing model, with the following assumptions: (i) no expected dividends; (ii) a risk-free interest rate of 2.34%; (iii) expected volatility of 48.0%; and (iv) an expected life of the warrants of ten years. The fair value of the warrants was recorded as debt discount cost of $241,336 and is amortized to interest expense over the term of the loan. The issued warrants expire on February 1, 2027, subject to automatic exercise upon expiration if they meet certain contingencies. At September 30, 2017, there were 355,776 warrants fully-vested and outstanding, recorded as a liability with a fair value of $233,589.

The aggregate annual maturities of the note payable are as follows:

| | | |
|---|---|---|
| Three months ended December 31, 2017 | | — |
| Twelve Months ended December 31, 2018 | | 2,777,778 |
| Twelve Months ended December 31, 2019 | | 3,333,333 |
| Twelve Months ended December 31, 2020 | | 3,333,333 |
| Twelve Months ended December 31, 2021 | | 555,556 |
| | $ | 10,000,000 |





## 5. Convertible Promissory Notes and Warrants

*Convertible Promissory Notes and Warrants Issued in 2014 and 2015*

In June 2014, the Company entered into a Note and Warrant Purchase Agreement (the "Purchase Agreement") whereby convertible promissory notes (the "Notes" or "Note") and warrants to purchase Series C preferred stock (the "Warrants") were issued to certain stockholders in exchange for cash ("Initial Closing"). The Notes issued in the Initial Closing have an aggregate principal amount of $4,000,000. In December 2014, the Purchase Agreement was amended whereby additional Notes in the aggregate principal amount of $1,250,000 and Warrants were issued to certain stockholders in exchange for cash ("Second Closing"). In January 2015, the Purchase Agreement was amended whereby additional Notes in the aggregate principal amount of $1,500,000 and Warrants were issued to certain stockholders in exchange for cash ("Third Closing"). In March 2015, the Purchase Agreement was amended whereby additional Notes in the aggregate principal amount of $2,000,000 and Warrants were issued to certain stockholders in exchange for cash ("Fourth Closing").

The Notes accrued interest at a rate of 8% per annum on the outstanding principal balance. In August 2015, the Company entered into a stock purchase agreement whereby an aggregate amount of 8,309,122 shares of Series D Convertible Preferred Stock were issued in exchange for conversion of the Indebtedness to the Note holders totaling $9,341,945.

In connection with the Notes issued under the Purchase Agreement (as amended), the Company issued Warrants to the Note holders to purchase 1,219,510, 381,093, 457,314 and 609,754 shares of the Company's Series C Preferred Stock on the First, Second, Third and Fourth Closings, respectively. The Warrants have an exercise price of $0.82 per share. The Warrants were fully exercisable on the date of issuance and expire ten years from the issuance date.

The fair value of the Warrants as of the issuance date was $768,497, $240,153, $274,693 and $366,258 for the Warrants issued on the First, Second, Third and Fourth Closings, respectively. The fair value was determined using the Black-Scholes option-pricing model with the following assumptions:

| | |
|---|---|
| Expected volatility | 52.5%-55.0% |
| Dividend yield | 0% |
| Risk-free interest rates | 1.83% to 2.59% |
| Expected term | 10 Years |

The fair value of the Warrants is presented as a debt discount on the Notes and amortized to interest expense over the term of the related Notes using the effective interest method and as a liability on the accompanying unaudited condensed balance sheet, which is revalued at each reporting period until the warrants are exercised or expire. As of September 30, 2017 and December 31, 2016, the warrants are recorded as a liability with a fair value of $1,454,626 and $1,516,787, respectively.

**5. Convertible Promissory Notes and Warrants (continued)**

*Convertible Promissory Notes Issued in 2017*

In January 2017, the Company entered into a Note Purchase Agreement (the "Note Purchase Agreement") whereby convertible promissory notes (the "Notes" or "Note") were issued to certain stockholders in exchange for cash in the principal amount of $11,000,000.

The Notes accrue interest at a rate of 8% per annum on the outstanding principal balance. The outstanding principal and any unpaid accrued interest thereon (the "Indebtedness") is due and payable on January 31, 2018, unless earlier converted into capital stock of the Company.

Prior to the maturity date, upon the consummation of a qualified financing or initial public offering, as defined, all Indebtedness under the Notes shall automatically convert into shares of the class of equity securities as are issued in the qualified financing or initial public offering, at a conversion price equal to seventy percent (70%) of the per-share price at which the related securities are sold in the qualified financing or initial public offering. Notwithstanding the foregoing, if the majority of note holders (as defined) agree to convert all outstanding principal and unpaid accrued interest on the Notes in a qualified financing, then all Notes shall convert into the same securities upon the same terms and conditions.

Upon the consummation of a change of control as defined in the Notes, if not previously converted as described above, the Note holders shall be entitled to receive, in preference to any other security of the Company, payment of three times the Indebtedness. The Notes are secured by certain assets of the Company. At September 30, 2017, the outstanding principal on the Notes is $11,000,000 and accrued interest in the amount of $583,452 is included in accrued and other liabilities in the unaudited condensed balance sheet. As more fully described in Note 9, the Company was acquired on October 2, 2017 by EnteroMedics, Inc. and the Notes were terminated in exchange for the merger consideration.

**6. Stockholders' Equity**

*Preferred Stock*

The Company has authorized 71,152,828 shares of Preferred Stock with a par value of $0.0001. The Preferred Stock is divided into series. The first series consists of 500,000 authorized shares and is designated Series S Convertible Preferred Stock. The second series consists of 4,687,500 authorized shares and is designated Series A Convertible Preferred Stock. The third series consists of 6,250,000 authorized shares and is designated Series B Convertible Preferred Stock. The fourth series consists of 25,916,528 authorized shares and is designated Series C Convertible Preferred Stock. The fifth series consists of 33,798,800 authorized shares and is designated Series D Convertible Preferred Stock.





**6. Stockholders' Equity (continued)**

*Series D Convertible Preferred Stock*

In August 2015, the Company entered into a stock purchase agreement whereby an aggregate amount of 25,489,678 shares of Series D Convertible Preferred Stock were issued in exchange for $28,658,047 in cash (gross). Additionally, 8,309,122 shares of Series D Convertible Preferred Stock were issued in August 2015 in exchange for conversion of Indebtedness to stockholders totaling $9,341,945 (Note 5).

The Series D Convertible Preferred Stock contains a liquidation preference described below. Shares of Series D Convertible Preferred Stock are convertible at the holder's option into shares of common stock, initially on a share-for-share basis using a conversion rate of $1.12 per share. The conversion ratio may be adjusted upon certain events and for certain dilutive issuances, splits and combinations. Conversion is automatic in the event of a public offering of the Company's common stock meeting certain specified criteria or upon the election of 67% of the holders of the Series D Preferred Stock, Series C Preferred Stock, Series B Preferred Stock, Series A Preferred Stock and Series S Preferred Stock, voting together as a single class.

Dividends, if declared or upon the liquidation or winding up of the Company, are non-cumulative and are payable at the rate of 8% of the Series D Preferred Stock's original issue price per annum on each share. No dividends have been declared through September 30, 2017. Each share of Series D Preferred Stock has voting rights equal to the number of shares of common stock into which it is then convertible. Shares of the Series D Preferred Stock are not redeemable.

In the event that the Company has an unrestricted cash position of less than $5,000,000 or the Board of Directors determines the Company must raise additional equity capital, other than an initial public offering, then each Investor holding shares of Series D Preferred Stock shall have the right to purchase a pro rata share of additional Series D Preferred Stock at the purchase price of $1.1243 per share (as adjusted for any stock dividends, contributions, splits, recapitalizations and the like with respect to such shares). The amount of capital to be raised under these circumstances shall be the greater of $15,000,000 in net cash proceeds or an amount determined by the Board of Directors.

**6. Stockholders' Equity (continued)**

*Series C Convertible Preferred Stock*

In October 2012, the Company entered into a stock purchase agreement whereby an aggregate amount of 9,859,756 shares of Series C Convertible Preferred Stock were issued in two closings (October 2012 and December 2012) in exchange for $8,085,001 in cash. Additionally, 3,747,141 shares of Series C Convertible Preferred Stock were issued in October 2012 in exchange for conversion of indebtedness to stockholders totaling $3,072,656. As a result of the indebtedness' beneficial conversion feature, the Company recognized additional interest expense of $341,406 in 2012 and issued 416,349 shares of Series C Preferred Stock. Related issuance costs aggregated $91,422.

In March 2013, the Company completed the final closing of the Series C Preferred Stock purchase agreement whereby an aggregate amount of 8,432,928 shares of Series C Convertible Preferred Stock was issued in exchange for $6,915,001 in cash. Related issuance costs aggregated $17,842.

The Series C Convertible Preferred Stock contains a liquidation preference described below. Shares of Series C Convertible Preferred Stock are convertible at the holder's option into shares of common stock, initially on a share-for-share basis using a conversion rate of $0.82 per share. The conversion ratio may be adjusted upon certain events and for certain dilutive issuances, splits and combinations. Conversion is automatic in the event of a public offering of the Company's common stock meeting certain specified criteria or upon the election of 67% of the holders of the Series D Preferred Stock, Series C Preferred Stock, Series B Preferred Stock, Series A Preferred Stock and Series S Preferred Stock, voting together as a single class.

Dividends, if declared or upon the liquidation or winding up of the Company, are non-cumulative and are payable at the rate of 8% of the Series C Preferred Stock's original issue price per annum on each share. No dividends have been declared through September 30, 2017. Each share of Series C Preferred Stock has voting rights equal to the number of shares of common stock into which it is then convertible. Shares of the Series C Preferred Stock are not redeemable.





**6. Stockholders' Equity (continued)**

*Series B Convertible Preferred Stock*

In October 2008, the Company entered into a stock purchase agreement whereby an aggregate amount of 6,250,000 shares of Series B Convertible Preferred Stock were issued in exchange for $20,000,000 in cash. Related issuance costs aggregated $120,767.

The Series B Convertible Preferred Stock contains a liquidation preference described below. Shares of Series B Convertible Preferred Stock are convertible at the holder's option into shares of common stock on a share-for-share basis using a conversion rate of $1.59 per share. The conversion ratio may be adjusted upon certain events and for certain dilutive issuances, splits and combinations. Conversion is automatic in the event of a public offering of the Company's common stock meeting certain specified criteria or upon the election of 67% of the holders of the Series D Preferred Stock, Series C Preferred Stock, Series B Preferred Stock, Series A Preferred Stock and Series S Preferred Stock, voting together as a single class.

Dividends, if declared or upon the liquidation or winding up of the Company, are non-cumulative and are payable at the rate of 8% of the Series B Preferred Stock's original issue price per annum on each share. No dividends have been declared through September 30, 2017. Each share of Series B Preferred Stock has voting rights equal to the number of shares of common stock into which it is then convertible. Shares of the Series B Preferred Stock are not redeemable.

*Series A Convertible Preferred Stock*

In May 2006, the Company entered into a stock purchase agreement whereby an aggregate amount of 2,812,500 shares of Series A Convertible Preferred Stock were issued in exchange for $4,500,000 in cash. Related issuance costs aggregated $73,932.

In August 2007, the Company entered into a stock purchase agreement whereby an aggregate amount of 1,875,000 shares of Series A Convertible Preferred Stock were issued in exchange for $3,000,000 in cash. Related issuance costs aggregated $22,408. The Series A Convertible Preferred Stock contains a liquidation preference described below. Shares of Series A Convertible Preferred Stock are convertible at the holder's option into shares of common stock on a share-for-share basis using a conversion rate of $1.12 per share. The conversion ratio may be adjusted upon certain events and for certain dilutive issuances, splits and combinations. Conversion is automatic in the event of a public offering of the Company's common stock meeting certain specified criteria or upon the election of 67% of the holders of the Series D Preferred Stock, Series C Preferred Stock, Series B Preferred Stock, Series A Preferred Stock and Series S Preferred Stock, voting together as a single class.

**6. Stockholders' Equity (continued)**

*Series A Convertible Preferred Stock (continued)*

Dividends, if declared or upon the liquidation or winding up of the Company, are non-cumulative and are payable at the rate of 8% of the Series A Preferred Stock's original issue price per annum on each share. No dividends have been declared through September 30, 2017. Each share of Series A Preferred Stock has voting rights equal to the number of shares of common stock into which it is then convertible. Shares of the Series A Preferred Stock are not redeemable.

*Series S Convertible Preferred Stock*

In September 2005, the Company entered into a stock purchase agreement whereby an aggregate amount of 500,000 shares of Series S Preferred Stock were issued in exchange for $500,000 in cash. Related issuance costs aggregated $39,998.

The Series S Convertible Preferred Stock contains a liquidation preference described below. Shares of Series S Convertible Preferred Stock are convertible at the holder's option into shares of common stock on a share-for-share basis using a conversion rate of $0.84 per share. The conversion ratio may be adjusted upon certain events and for certain dilutive issuances, splits and combinations. Conversion is automatic in the event of a public offering of the Company's common stock meeting certain specified criteria or upon the election of 67% of the holders of the Series C Preferred Stock, Series B Preferred Stock, Series A Preferred Stock and Series S Preferred Stock, voting together as a single class.

Dividends, if declared or upon the liquidation or winding up of the Company, are non-cumulative and are payable at the rate of 8% of the Series S Preferred Stock's original issue price per annum on each share. No dividends have been declared through September 30, 2017. Each share of Series S Preferred Stock has voting rights equal to the number of shares of common stock into which it is then convertible. Shares of the Series S Preferred Stock are not redeemable.

*Liquidation Preferences*

Upon liquidation, dissolution or winding up of the Company, the holders of Series D Preferred Stock, on a pro rata basis, are entitled to receive, prior and in preference to any distribution from the assets of the Company to the holders of all other series of Preferred Stock and the holders of common stock, an amount per share equal to the original issue price of the Series D Preferred Stock, plus all declared but unpaid dividends.

After payment of the above amounts, the holders of the Series S Preferred Stock, Series A Preferred Stock, Series B Preferred Stock and Series C Preferred Stock, on a pro rata basis, are entitled to receive, prior and in preference to any distribution from the assets of the





**6. Stockholders' Equity (continued)**

*Liquidation Preferences (continued)*

Company to the holders of common stock, an amount per share equal to the original issue price of the Series S Preferred Stock, Series A Preferred Stock, Series B Preferred Stock and Series C Preferred Stock, plus all declared but unpaid dividends.

After payment of the above amounts, the remaining assets of the Company available for distribution to the stockholders shall be distributed to the holders of the common stock.

*Common Stock*

The Company has authorized 105,000,000 shares of common stock with a par value of $0.0001.

In August 2005, the Company issued 1,625,000 shares of its common stock to founders in exchange for cash totaling $1,625.

In 2008, the Company issued 375,000 shares of the Company's common stock to consultants, subject to the terms of the 2005 Stock Incentive Plan and Restricted Stock Award Agreements as consideration for services provided. The aggregate value of the shares at issuance was as follows:

| | Number of Shares | Value per Share | Aggregate Value of Shares |
|---|---|---|---|
| January 2008 | 250,000 | $ 0.25 | $ 62,500 |
| July 2008 | 87,500 | $ 0.25 | $ 21,875 |
| November 2008 | 37,500 | $ 0.48 | $ 18,000 |

The Company has a right of first refusal to purchase all or any shares offered for sale at the price specified in the offer. The rights provided the Company shall terminate upon the consummation of a public offering or immediately prior to the consummation of a change in control whereupon the shares will be exchanged for shares of a successor corporation, which corporation is publicly held.

In 2008, the Company issued 400,000 shares of the Company's common stock to a key employee, subject to the terms of the 2005 Stock Incentive Plan and a Restricted Stock Purchase Agreement in exchange for cash of $100,000. The restricted stock is subject to a right of first refusal as defined in the Restricted Stock Purchase Agreement.





**6. Stockholders' Equity (continued)**

*Warrants*

In November 2011, the Company issued warrants to an outside consultant to purchase 26,533 shares of the Company's common stock at a per share price of $0.44 in exchange for services. The warrants expire on November 22, 2021 and as of December 31, 2016 all the warrants are fully-vested and outstanding.

In August 2013, the Company issued warrants to an outside consultant to purchase 36,836 shares of the Company's common stock at a per share price of $0.18 in exchange for services. The warrants expire on August 22, 2023 and as of December 31, 2016 all the warrants are fully-vested and outstanding.

**7. Commitments and Contingencies**

*Operating Leases*

In January 2017, the Company entered into an operating lease for a facility to serve as its new headquarters office in San Clemente, California. The lease commenced on April 1, 2017 and expires on June 30, 2022.

In January 2017, the Company extended an operating lease for its manufacturing facility located in San Clemente, California. The extension was to a prior lease on the same property dated October 12, 2015. The January 2017 lease amendment extended the terms of the lease through October 31, 2019.

Future minimum lease payments required under these leases are as follows for the following periods:

| | | |
|---|---|---|
| Three months ended December 31, 2017 | $ | 106,297 |
| Twelve Months ended December 31, 2018 | | 431,624 |
| Twelve Months ended December 31, 2019 | | 419,082 |
| Twelve Months ended December 31, 2020 | | 319,262 |
| Twelve Months ended December 31, 2021 | | 327,949 |
| Twelve Months ended December 31, 2022 | | 165,061 |
| | $ | 1,769,275 |

Rent expense for the three and nine months ended in September 30, 2017 was $117,896 and $387,003, respectively and for the three and nine months ended September 30, 2016 was $185,118 and $544,744, respectively.





**7. Commitments and Contingencies (continued)**

*Litigation*

On April 20, 2017, Fulfillium, Inc., filed a Complaint in the United States District Court for the District of Delaware accusing the Company of trade secret misappropriation under the California Uniform Trade Secrets Act (CA. Civ. Code §3426 et seq.) and/or Delaware law (Code Ann. Title 6 §2001 et seq); and infringement of U.S. Patent Nos. 9,445,930 and 9,456,915. On July 28, 2017, Reshape Medical, Inc. filed a Rule 12(b)(6) motion to dismiss the trade secrets claims as time-barred and/or for failure to state a claim and to dismiss most of the patent infringement claims for failure to state a claim. The Company also filed a motion to transfer the litigation to the United States District Court for the Central District of California. On October 10, 2017, Fulfillium filed a motion seeking leave to amend its complaint to add an investor in the Company as a co-defendant, but did not amend the substantive allegations of its original Complaint that are the basis of the pending motion to dismiss. The Company filed an opposition to the motion for leave to amend on October 24, 2017 and Fulfillium filed its Reply on October 31, 2017. The motions to dismiss and transfer were heard on November 7, 2017, and on November 9, 2017, the Court issued an Order granting-in-part the motion to dismiss, dismissing the trade secret claim and allegations of willful infringement, with leave to amend, and transferring the case to the United States District Court for the Central District of California. The Court did not rule on the motion for leave to amend the complaint to add the proposed new party, which remains fully briefed. On November 20, 2017, Fullfillium filed an amended complaint, which abandoned some trade secret claims, and included additional allegations regarding other of its trade secret claims and claims for willful infringement. On December 6, 2017 the Company moved to dismiss the amended trade secret misappropriation claims and amended willful infringement claims. The Company also moved for reconsideration of denial of its prior motion to dismiss certain aspects of the patent infringement claims. Oral arguments on the Company's pending motions is scheduled for January 8, 2018 and an initial case management conference for the litigation has been scheduled for March 19, 2018. The probable outcome of this litigation cannot be determined, nor can the Company estimate any possible range of potential loss at this time. Management of the Company intends to vigorously defend against the claims and believes the risk of loss remote.

Except as disclosed in the foregoing paragraph, the Company is not currently a party to any litigation and the Company is not aware of any pending or threatened litigation against it that could have a material adverse effect on the Company's business, operating results or financial condition. The medical device industry in which the Company operates is characterized by frequent claims and litigation, including claims regarding patent and other intellectual property rights as well as improper hiring practices. As a result, the Company may be involved in various legal proceedings from time to time.





**7. Commitments and Contingencies (continued)**

*Litigation (continued)*

From time to time, the Company may be involved in certain legal matters which arise in the normal course of operations. Management believes that the resolution of such matters will not have a material adverse effect on the financial position or results of operations of the Company.

**8. Related Party Transactions**

The Company is a party to consulting agreements with two members of its Board of Directors. The agreements provide for fees to be paid in exchange for business strategy, regulatory and product development advisory services. In exchange for these services, for the three and nine months ended September 30, 2017, the Company issued payments to the board members in the combined amounts of $50,921 and $142,089, respectively, and for the three and nine months ended September 30, 2016 in the combined amounts of $62,055 and $135,509, respectively.

*Indemnities*

During the normal course of business, the Company has made certain indemnities under which it may be required to make payments in relation to certain transactions. These indemnities include (i) certain real estate leases, under which the Company may be required to indemnify property owners for general liabilities; and (ii) certain agreements with the Company's officers and directors, under which the Company may be required to indemnify such persons for liabilities arising out of their employment relationship and (iii) certain agreements with customers, under which the Company may be required to indemnify the customer for product related liabilities. The duration of these indemnities do not provide for any limitation of the maximum potential future payments that Company could be obligated to make. Historically, the Company has not been obligated to make significant payments for these obligations and no liabilities have been recorded for these indemnities in the accompanying unaudited condensed balance sheet.

**9. Subsequent Events**

On October 2, 2017 the Company was acquired by EnteroMedics Inc. (the acquirer), a publicly-traded corporation focused on the development and commercialization of minimally invasive medical devices to treat obesity, metabolic diseases and other gastrointestinal disorders. Subsequent to the transaction, the Company began operating as a wholly-owned subsidiary of the acquirer.





**9. Subsequent Events (continued)**

Under the terms of the merger agreement, the consideration paid by the acquirer consisted of 2,356,729 shares of acquirer common stock, 187,772 shares of series C convertible preferred stock of the acquirer (which will be convertible into 18,777,200 shares of common stock upon the receipt of the required approval of the acquirer's stockholders under NASDAQ rules), and approximately $5.0 million in cash, which amount was immediately used to pay the Company's outstanding senior secured indebtedness and certain transaction expenses of the Company.

As more fully described in note 5 to these condensed unaudited financial statements, in January 2017 the Company issued Convertible Promissory Notes in the principal amount of $11,000,000 which, along with accrued interest in the amount of $583,452 remain outstanding as of September 30, 2017. The total outstanding principal plus accrued interest, equal to $11,583,452 represents the amount of "Indebtedness" as defined in the Note Purchase Agreement. The Note Purchase Agreement contained a provision, that in the event of a change of control of the Company, as defined, the

Note holders were to receive, in preference to any other security of the Company, payment of three times the Indebtedness (the "Liquidation Payment"). As the merger constituted a change of control, simultaneously with the closing of the merger agreement, the notes were amended and the outstanding Convertible Promissory Note balances were cancelled and converted automatically into the right of the Note holders to receive, in full satisfaction of the rights of such Note holders, shares of the acquirer's common stock and series C convertible preferred stock having an aggregate value equal to three times the Indebtedness.

On October 23, 2017, the acquirer changed its name to ReShape Lifesciences Inc.

The Company has evaluated subsequent events through December 15, 2017, which is the date the financial statements are available for issuance, and concluded that there were no events or transactions that need to be disclosed other than those disclosed throughout these financial statements.

**Exhibit 99.4**

# UNAUDITED PRO FORMA CONDENSED COMBINED FINANCIAL STATEMENTS

On October 2, 2017 the Company (ReShape Lifesciences Inc. or RSLS and known as EnteroMedics Inc. prior to October 23, 2017) acquired ReShape Medical, Inc. (ReShape Medical), a privately-held medical technology company that develops, manufactures and markets the ReShape® Dual Weight Loss Balloon, an FDA and CE marked approved, minimally invasive intragastric balloon designed to treat obesity patients with a body mass index (BMI) between 30 and 40, with one or more related comorbid conditions.

Under the terms of the merger agreement, the consideration paid by the Company for ReShape Medical consisted of 2,356,729 shares of common stock, 187,772 shares of series C convertible preferred stock (which will be convertible into 18,777,200 shares of common stock upon the receipt of the required approval of the Company's stockholders under NASDAQ rules), and approximately $5.0 million in cash, which amount was immediately used to pay ReShape Medical's outstanding senior secured indebtedness and certain transaction expenses of ReShape Medical. The Company agreed to hold a special meeting of its stockholders by December 31, 2017 to seek the required approval of the conversion of the series C convertible preferred stock into shares of common stock. The special meeting of stockholders is scheduled for December 19, 2017.

The total consideration paid by the Company, preliminarily valued at $39.0 million, includes: (a) $5.0 million in cash paid from existing cash balances of RSLS and (b) $34.0 million from the issuance of common stock and series C convertible preferred stock.

The Company expects that the ReShape Medical acquisition will be accounted for as a business combination and the Company will record the assets and liabilities acquired at their respective fair values during the fourth quarter of 2017.

The following Unaudited Pro Forma Condensed Combined Statements of Operations for the nine months ended September 30, 2017, and for the year ended December 31, 2016, combine the historical consolidated statements of operations of RSLS and ReShape Medical for those periods, giving effect to the transaction as if it had been consummated on January 1, 2016. The Unaudited Pro Forma Condensed Combined Financial Statements were prepared using the acquisition method of accounting in accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 805, Business Combinations, with RSLS considered as the accounting acquirer and ReShape Medical as the accounting acquiree. Accordingly, consideration paid by the Company to complete the transaction will be allocated to identifiable assets and liabilities of ReShape Medical based on their estimated fair values as of the closing date of the transaction. As of the date of the Form 8-K/A filing to which these Pro Forma Condensed Combined Financial Statements are attached (the "Form 8-K/A"), the Company has not completed the detailed valuation analysis necessary to arrive at the required estimates of the fair value of ReShape Medical's assets acquired and the liabilities assumed and the related allocations of purchase price, nor has it identified all adjustments necessary to conform ReShape Medical's accounting policies to RSLS' accounting policies. A final determination of the fair value of ReShape Medical's assets and liabilities, including intangible assets with both indefinite or definite lives, will be based on the actual net tangible and intangible assets and liabilities of ReShape Medical that existed as of the closing date of the transaction and, therefore, cannot be made prior to the preparation of the financial statements of ReShape Medical after closing. As a result of the foregoing, the pro forma adjustments are preliminary and are subject to change as additional information becomes available and as additional analyses are performed. The Company has prepared preliminary estimates of the fair value of ReShape Medical's assets and liabilities based on discussions with ReShape Medical' s management, preliminary valuation analyses and due diligence which are reflected in the Unaudited Pro Forma Condensed Combined Financial Statements. Any increases or decreases in the fair value of relevant balance sheet amounts upon completion of the final valuations will result in differences from the Unaudited Pro Forma Condensed Combined Balance Sheet and Statements of Operations and these differences may be material.

---

Assumptions and estimates underlying the unaudited adjustments to the pro forma condensed combined financial information (the "pro forma adjustments") are described in the accompanying notes. The historical consolidated financial statements have been adjusted in the unaudited pro forma condensed combined financial information to give effect to pro forma events that are: (1) directly attributable to the transaction; (2) factually supportable; and (3) with respect to the Unaudited Pro Forma Condensed Combined Statement of Operations, expected to have a continuing impact on the combined results following the transaction. The unaudited pro forma condensed combined financial information has been presented for illustrative purposes only and is not necessarily indicative of the operating results and financial position that would have been achieved had the transaction occurred on the date indicated. Further, the unaudited pro forma condensed combined financial information does not purport to project the future operating results or financial position of the combined company following the transaction.

These Unaudited Pro Forma Condensed Combined Financial Statements have been derived from, and should be read in conjunction with:

- The unaudited condensed consolidated financial statements of the Company as of and for the three and nine-month periods ended September 30, 2017, as contained in its Quarterly Report on Form 10-Q filed on November 14 , 2017;
- The audited consolidated financial statements of the Company as of and for the years ended December 31, 2016 and 2015, as contained in its Annual Report on Form 10-K filed on March 8, 2017;
- The audited financial statements of ReShape Medical as of and for the years ended December 31, 2016 and 2015, included as Exhibit 99.1 & 99.2 of this Form 8-K/A; and
- The unaudited financial statements of ReShape Medical as of and for the three and nine months ended September 30, 2017, included as Exhibit 99.3 of this Form 8-K/A.

The Unaudited Pro Forma Condensed Combined Financial Statements do not reflect the costs of any integration activities or any future cost savings from combined operations pursuant to the transaction. Although the Company believes that there may be integration costs and that cost savings will be realized following the transaction, there can be no assurance that these costs savings will be achieved in full or at all. In addition, the Unaudited Pro Forma Condensed Combined Statements of Operations do not include other one-time costs directly attributable to the transaction or professional fees incurred by the Company or ReShape Medical as they are not expected to have a continuing impact on the combined company.

---

**ReShape Lifesciences Inc.**
**Unaudited Pro Forma Condensed Combined Statement of Operations**
**Nine Months Ended September 30, 2017**

| | Historical ReShape Medical, Inc. | Historical RSLS (ReShape Lifesciences Inc.) | Acquisition & Financing Adjustments (1) | Note References | Proforma Combined |
|---|---|---|---|---|---|
| Revenues | $ 2,587,754 | $ 493,120 | $ — | | $ 3,080,874 |
| Cost of revenues | 1,946,029 | 298,506 | — | | 2,244,535 |
| Gross profit | 641,725 | 194,614 | — | | 836,339 |
| Operating expenses: | | | | | |
| Selling, general and administrative | 10,231,970 | 16,085,311 | 2,194,599 | 5a, 5g | 28,511,880 |
| Research and development | 2,158,705 | 3,586,129 | — | | 5,744,834 |
| Total operating expenses | 12,390,675 | 19,671,440 | 2,194,599 | | 34,256,714 |
| Operating loss | (11,748,950) | (19,476,826) | (2,194,599) | | (33,420,375) |
| Other income (expense): | | | | | |
| Interest income | 63,900 | 100 | (63,900) | 5h | 100 |
| Interest expense | (1,338,523) | — | 1,338,523 | 5h | — |
| Warrants expense | — | (4,438,149) | | | (4,438,149) |
| Change in value of warrant liability | 92,835 | (283,688) | (92,835) | 5i | (283,688) |
| Other, net | (8,366) | (2,102) | — | 5b | (10,468) |
| Net loss | $ (12,939,104) | $ (24,200,665) | $ (1,012,811) | | $ (38,152,580) |
| Net loss per share—basic and diluted | | $ (3.19) | | | $ (3.84) |
| Shares used to compute basic and diluted net loss per share | | 7,589,239 | 2,356,729 | 5c | 9,945,968 |

(1) See Note 5 to the Unaudited Pro Forma Condensed Combined Financial Statements

## ReShape Lifesciences Inc.
## Unaudited Pro Forma Condensed Combined Statement of Operations
## Year Ended December 31, 2016

| | Historical ReShape Medical, Inc. | Historical RSLS (ReShape Lifesciences Inc.) | Acquisition & Financing Adjustments (1) | Note References | Proforma Combined |
|---|---|---|---|---|---|
| Revenues | $ 5,959,273 | $ 786,660 | $ — | | $ 6,745,933 |
| Cost of revenues | 5,433,965 | 431,476 | — | | 5,865,441 |
| Gross profit | 525,308 | 355,184 | — | | 880,492 |
| Operating expenses: | | | | | |
| Selling, general and administrative | 13,253,521 | 17,981,525 | 2,926,133 | 5a, 5g | 34,161,179 |
| Research and development | 3,881,227 | 5,169,286 | — | | 9,050,513 |
| Impairment charges and lease termination costs | 674,025 | — | — | | 674,025 |
| Total operating expenses | 17,808,773 | 23,150,811 | 2,926,133 | | 43,885,717 |
| Operating loss | (17,283,465) | (22,795,627) | (2,926,133) | | (43,005,225) |
| Other income (expense): | | | | | |
| Interest income | 60,090 | 5,837 | (29,999) | 5h | 35,928 |
| Interest expense | (803,082) | (4,104,003) | 803,082 | 5h | (4,104,003) |
| Change in value of warrant liability | 23,509 | 3,512,816 | (23,509) | 5i | 3,512,816 |
| Other, net | (14,716) | 20,133 | — | 5b | 5,417 |
| Net loss | $ (18,017,664) | $ (23,360,844) | $ (2,176,559) | | $ (43,555,067) |
| Net loss per share—basic and diluted | | $ (37.53) | | | $ (14.62) |
| Shares used to compute basic and diluted net loss per share | | 622,431 | 2,356,729 | 5c | 2,979,160 |

(1) See Note 5 to the Unaudited Pro Forma Condensed Combined Financial Statements

## ReShape Lifesciences Inc.
## Unaudited Pro Forma Condensed Combined Balance Sheet
## As of September 30, 2017

| | Historical ReShape Medical, Inc. | Historical RSLS (ReShape Lifesciences Inc.) | Acquisition & Financing Adjustments (1) | Note References | Proforma Combined |
|---|---|---|---|---|---|
| **ASSETS** | | | | | |
| Current assets: | | | | | |
| Cash and cash equivalents | $ 6,313,490 | $ 23,433,297 | $ (10,069,840) | 5d | $ 19,676,947 |
| Accounts receivable, net | 385,690 | 333,057 | — | | 718,747 |
| Inventory | 1,095,975 | 1,586,629 | — | | 2,682,604 |
| Prepaid expenses and other current assets | 189,461 | 252,473 | — | | 441,934 |
| Total current assets | 7,984,616 | 25,605,456 | (10,069,840) | | 23,520,232 |

| | | | | | |
|---|---|---|---|---|---|
| Property and equipment, net | 303,291 | 195,514 | — | | 498,805 |
| Intangible assets, net | — | 21,842,409 | 29,302,558 | 5a | 51,144,967 |
| Goodwill | — | 6,397,671 | 7,790,991 | 4 | 14,188,662 |
| Other assets | 77,058 | 1,142,304 | — | | 1,219,362 |
| Total assets | $ 8,364,965 | $ 55,183,354 | $ 27,023,709 | | $ 90,572,028 |
| | | | | | |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | | | | |
| Current liabilities: | | | | | |
| Accounts payable and accrued expenses | $ 1,405,317 | $ 4,133,765 | $ | | $ 5,539,082 |
| Accrued interest | 583,452 | — | (583,452) | 5d | — |
| Current portion of notes payable-bank | 1,944,444 | — | (1,944,444) | 5d | — |
| Convertible notes payable | 11,000,000 | | (11,000,000) | 5e | — |
| Total current liabilities | 14,933,213 | 4,133,765 | (13,527,896) | | 5,539,082 |
| Notes payble-bank (less current portion and unamortized debt discount) | 7,541,944 | | (7,541,944) | 5d | — |
| Common stock warrant liability | 2,066,687 | 2,159 | (2,066,687) | 5e | 2,159 |
| Total liabilities | 24,541,844 | 4,135,924 | (23,136,527) | | 5,541,241 |
| | | | | | |
| Stockholders' equity: | | | | | |
| Preferred stock | 6,770 | 10,112 | (4,892) | 5f | 11,990 |
| Common stock | 272 | 122,087 | 23,295 | 5f | 145,654 |
| Additional paid-in capital | 85,847,604 | 376,057,278 | (51,889,692) | 5f | 410,015,190 |
| Accumulated deficit | (102,031,525) | (325,142,047) | 102,031,525 | 5f | (325,142,047) |
| Total stockholders' equity | (16,176,879) | 51,047,430 | 50,160,236 | | 85,030,787 |
| Total liabilities and stockholders' equity | $ 8,364,965 | $ 55,183,354 | $ 27,023,709 | | $ 90,572,028 |

(1) See Notes 4 and 5 to the Unaudited Pro Forma Condensed Combined Financial Statements

**ReShape Lifesciences Inc.,**
**Notes to Pro Forma Condensed Combined Financial Statements**
**(Unaudited)**

**Note 1 - Description of Acquisition**

On October 2, 2017 the Company (ReShape Lifesciences Inc. or RSLS and known as EnteroMedics Inc. before October 23, 2017) acquired ReShape Medical, Inc. (ReShape Medical), a privately-held medical technology company that develops, manufactures and markets the ReShape® Dual Weight Loss Balloon, an FDA and CE marked approved, minimally invasive intragastric balloon designed to treat obesity patients with a body mass index (BMI) between 30 and 40, with one or more related comorbid conditions.

Under the terms of the merger agreement, the consideration paid by the Company for ReShape Medical consisted of 2,356,729 shares of common stock, 187,772 shares of series C convertible preferred stock (which will be convertible into 18,777,200 shares of common stock upon the receipt of the required approval of the Company's stockholders under NASDAQ rules), and approximately $5.0 million in cash, which amount was immediately used to pay ReShape Medical's outstanding senior secured indebtedness and certain transaction expenses of ReShape Medical. The Company agreed to hold a special meeting of its stockholders by December 31, 2017 to seek the required approval of the conversion of the series C convertible preferred stock into shares of common stock. This special meeting of stockholders is scheduled for December 19, 2017.

The total consideration paid by the Company, preliminarily valued at $39.0 million, includes: (a) $5.0 million in cash paid from existing cash balances of ReShape Lifesciences and (b) $34.0 million from the issuance of common stock and series C convertible preferred stock.

The Company expects that the ReShape Medical acquisition will be accounted for as a business combination and the Company will record the assets and liabilities acquired at their respective fair values during the fourth quarter of 2017.

The shares of common stock issued at the closing of the transaction represent approximately 19.3%of the total outstanding shares of common stock immediately prior to the transaction and approximately 16.2% of the total outstanding shares of common stock immediately following the transaction. Collectively, the shares of common stock and series C preferred stock issued in connection with the transaction represent approximately 49.0% of the issued and outstanding capital stock of the Company following the transaction, assuming conversion of the series C preferred stock and all of the Company's other outstanding shares of preferred stock into shares of common stock. The former ReShape Medical holders will not be permitted to convert their shares of series C preferred stock into shares of common stock to the extent that such conversion would cause them to hold more than 49.0% of the Company's outstanding voting securities at the time of any such conversion. Other than with respect to certain specific matters set forth in the Certificate of Designation of Preferences, Rights and Limitations of Series C Preferred Stock, shares of series C preferred stock will be non-voting until the receipt of the required Company stockholder approval and their conversion in shares of common stock. Upon the post-closing approval of the Company's stockholders, a portion of the shares of series C preferred stock will automatically convert into approximately 8,238,400 shares of common stock and the remaining shares of series C preferred stock will thereafter be convertible into shares of common stock at the option of the holders of the shares. However, if the volume weighted average price of the common stock exceeds $5.00 per share for at least 20 trading days, then all the outstanding shares of the series C preferred stock will automatically convert into shares of common stock.

**Note 2 - Basis of Presentation**

The Unaudited Pro Forma Condensed Combined Financial Statements are prepared in accordance with Article 8, rule 8-05, of the Securities and Exchange Commission Regulation S-X. The historical financial information has been adjusted to give effect to the transactions that are (i) directly attributable to the acquisition, (ii) factually supportable and (iii) with respect to the Unaudited Pro Forma Condensed Combined Statements of Operations, expected to have a continuing impact on the operating results of the combined company. The historical information of RSLS and ReShape Medical is presented in accordance with generally accepted accounting principles in the United States of America ("U.S. GAAP"), except that it does not contain all of the footnote disclosures normally required by U.S. GAAP.

At this time, the Company is not aware of any material differences in accounting policy or classification between its financial statements and those of ReShape Medical, however, the Company will continue to review ReShape Medical's accounting policies in an effort to determine whether any reclassification of amounts recorded by ReShape Medical in its results of operations or in its statements of financial condition may be required. As a result of that review, the Company may identify differences between the accounting policies and classifications of the two companies that, when conformed, could have a material impact on these Unaudited Pro Forma Condensed Combined Financial Statements.

**Note 3 - Calculation of Preliminary Estimated Purchase Price and Transaction Financing**

The acquisition was financed with (i) the issuance of 2,356,729 shares of common stock, (ii) the issuance of 187,772 shares of series C convertible preferred stock (which will be convertible into 18,777,200 shares of common stock upon the receipt of the required approval of the Company's stockholders under NASDAQ rules), and (iii) approximately $5.0 million in cash, which amount was immediately used to pay ReShape Medical's outstanding senior secured indebtedness and certain transaction expenses of ReShape Medical. For purposes of the Unaudited Pro Forma Condensed Combined Financial Statements the Company has preliminarily valued at $39.0 million all the consideration paid in conjunction with the acquisition, with $34.0 million representing the preliminary valuation of common stock and series C convertible preferred stock. The preliminary valuation of the common stock and series C convertible preferred stock took into account (i) the conversion ratio of the series C convertible preferred stock, (ii) the average closing price of the Company's common stock on the NASDAQ Stock Market on the date the transaction was announced, and (iii) a discount for lack of marketability related to the shares issued in the transaction.

**Note 4 - Preliminary Estimated Purchase Price Allocation**

Under the acquisition method of accounting, the total purchase price, which equals fair value, is allocated to the tangible and identifiable intangible assets acquired and liabilities assumed based on their estimated fair values as of the date of the acquisition.

The Company has performed a preliminary estimate of the fair market value of ReShape Medical's tangible and intangible assets and liabilities. The table below represents management's preliminary estimated fair value allocation of the total estimated consideration to ReShape Medical's tangible and intangible assets and liabilities as of September 30, 2017:

| | |
|---|---|
| Total consideration | $ 38,982,433 |
| Tangible net assets acquired | (1,888,884) |
| Identifiable intangible assets acquired | (29,302,558) |
| Consideration allocated to goodwill | $ 7,790,991 |

This preliminary estimated purchase price allocation has been used to prepare pro forma adjustments in these Unaudited Pro Forma Condensed Combined Financial Statements. Upon completion of the fair value assessment after the closing, it is anticipated that the final purchase price allocation will differ from the preliminary assessment outlined above. Any changes to the initial estimates of the fair value of assets and liabilities that are made within the measurement period, which will not exceed one year from the closing, will be recorded as adjustments to those assets and liabilities and residual amounts will be allocated to goodwill.

**Note 5 - Pro Forma Adjustments**

The Unaudited Pro Forma Condensed Combined Statements of Operations do not include any material non-recurring charges directly attributable to the acquisition that will arise in subsequent periods. In addition, the Unaudited Pro Forma Condensed Combined Financial Statements do not reflect the costs of any integration activities including any benefits that may result from realization of future cost savings from operating efficiencies or revenue synergies expected to result from the acquisition. The Unaudited Pro Forma Condensed Combined Financial Statements reflect the following adjustments.

***(a) Tangible and Intangible Assets — Fair Value Adjustments***

The preliminary valuation identified intangible assets consisting of developed technology, customer relationships and trademarks. The fair value of acquired intangible assets was estimated by management at $29.3 million. The calculation of these fair values is preliminary and subject to change. The following table summarizes the estimated fair values of ReShape Medical's identifiable intangible assets and their estimated useful lives and uses a straight-line method of amortization:

| | | | Amortization Expense | |
|---|---|---|---|---|
| | Estimated Fair Value | Estimated Useful Life in Years | Nine Months Ended September 30, 2017 | Year Ended December 31, 2016 |
| Developed Technology | $ 22,768,577 | 12 | $ 1,423,035 | $ 1,897,381 |
| Customer relationships | 3,753,533 | 5 | 563,031 | 750,707 |
| Trademarks | 2,780,448 | 10 | 208,533 | 278,045 |
| Pro forma adjustments to intangible assets | $ 29,302,558 | | $ 2,194,599 | $ 2,926,133 |

***(b) Income Tax Expense/Benefit***

The Pro Forma Unaudited Statement of Operations do not reflect an adjustment to income tax expense/benefit for any of the periods presented because the combined operations generated a loss. No deferred income tax asset is recorded because the accounting criteria to record such assets has not been met.

***(c) Loss per Share***

Reflects an adjustment to increase basic and diluted weighted average shares for the issuance of 2,356,729 common shares as of the closing of the date of the transaction. Series C convertible preferred stock issued as part of the consideration for the transaction are not included as it would be anti-dilutive.

***(d) Cash***

Represents the assumed usage of $10.1 million of cash at closing by ReShape Medical to pay the following accrued interest and notes payable principal amounts:

| | | |
|---|---|---|
| Accrued interest | $ | 583,452 |
| Current portion of notes payable-bank | | 1,944,444 |
| Long-term portion of notes payable-bank | | 7,541,944 |
| Total usage of cash at closing | $ | 10,069,840 |

***(e) Convertible Notes Payable & Common Stock Warrant Liability***

Under the terms of the merger agreement, any remaining outstanding convertible note balances of ReShape Medical were cancelled and converted automatically into the right of the holder of the convertible note to receive, in full satisfaction of the rights of such holder with respect thereto, shares of the Company's common stock and series C convertible preferred stock having an aggregate value equal to three times the outstanding principal and unpaid interest under the convertible note, in accordance with the terms of the convertible notes. In addition, all outstanding warrants of ReShape Medical were cancelled without any payment or other consideration being made in respect thereof. The adjustment reflects the termination and cancellation of $11.0 million of convertible notes principal and $2.1 million of common stock warrant liabilities.

***(f) Stockholders' Equity***

Reflects the issuance of 2,356,729 million shares of common stock, par value $0.01 per share, and 187,772 shares of convertible preferred stock, par value $0.01 per share, together valued at approximately $34.0 million at closing. Also, reflects the cancellation of $11.0 million of convertible notes and $2.1 million of common stock warrant liabilities of ReShape Medical, to the extent not paid off at closing by ReShape Medical, consistent with the terms of the merger agreement. Additionally, reflects the elimination of the historical preferred stock, common stock, additional paid-in capital and accumulated deficit of ReShape Medical of $6,770, $272, $85.8 million, and $102.0 million, respectively, at closing.

***(g) Summary of Pro Forma Adjustments Affecting Amortization Expense***

The table below summarizes all the pro forma entries, outlined above, that affect amortization expense for the nine months ended September 30, 2017 and the twelve months ended December 31, 2016:

| | | Nine Months Ended Sept 30, 2017 | | Year Ended December 31, 2016 |
|---|---|---|---|---|
| ***Selling, General and Administrative Expenes*** | | | | |
| ***Add:*** | | | | |
| Amortization expense | $ | 2,194,599 | $ | 2,926,133 |

***(h) Summary of Pro Forma Adjustments Affecting Interest Income & Interest Expense***

Reflects the adjustment to reduce interest income and interest expense of ReShape Medical related to the assumed use of beginning of the period cash balances to pay off debt balances to zero.

***(i) Summary of Pro Forma Adjustments Affecting Change in Value of Warrant Liability***

Reflects the adjustment to reduce to zero the change in the value of ReShape Medical's warrant liability. Under the terms of the transaction, these common stock warrants were terminated and cancelled at closing, which is assumed to occur at the beginning of the period.